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International Outlook 1986

Economists with major U.S. corporations participating in The Conference Board's tenth annual survey on the international economic outlook, presented this year in a new format, predict continued modest growth in the principal industrial countries during 1986. According to these economists and a few of their European colleagues, who were polled in late September/early October:

- Real economic growth will average between 2.3 and 2.5 percent in Europe, around 2.5 percent in Canada, and 3.5 percent in Japan.
- Inflation will moderate to around 5.5 percent in Europe, remain unchanged at 2.5 percent in Japan, and increase slightly to 4.5 percent in Canada.
- The dollar will weaken further, albeit gradually, against other major currencies throughout 1986.

Modest Growth Ahead

The overall picture emerging from the survey is slightly less optimistic than the 1986 forecasts of such official organizations as the International Monetary Fund and the Organization for Economic Cooperation and Development (OECD). In fact, in view of the general world economic situation, the survey results can even be characterized as slightly disappointing.

For one thing, the survey reveals that any slack that might appear during 1986 in U.S. import demand will not be taken up by vigorous business activity in the other industrial countries. Nor do the business economists and strategists believe that the commitments made at the September 22 G-5 summit meeting by such major players as Germany and Japan ("strengthening the underlying conditions for continuing, vigorous, job-creating growth" and "institute policies intended to insure sustainable noninflationary growth") will be implemented in 1986.

Forecast Highlights
1986 GNP Growth
Four European Countries

France	2.0%
Germany	3.0
Italy	2.2
United Kingdom	2.4

Panelists noted a considerable degree of convergence in economic activity abroad. Accordingly, they expect relatively little difference in the performance of individual economies. For the six major countries outside the United States, their median projections range only between 2.0 and 3.5 percent. That dispersion contrasts with an estimated range of 1.6-4.5 percent for growth in 1985 (Table 1).

Germany is viewed as likely to record a three percent growth rate in 1986 (up from 2.5-2.8 percent in 1985), as higher domestic investment and consumption replaces the strong export performance of the past few years. That is a little lower than the official forecast of nearly 3.5 percent and is not compatible with a significant decline in either Germany's unemployment rate or trade surplus. The French economy likewise will probably show slightly faster growth in 1986 than during 1984-5. While Japan will grow faster than both the United States and Europe, its performance in 1986 could well be lower than in 1985 unless the authorities adopt additional and stronger expansionary measures. According to many panelists, the October 1985 economic stimulus package is unlikely to make up for the demand provided by exports over the past three years.

Forecast Highlights
1986 Inflation Rates
Four European Countries

France	5.5%
Germany	2.5
Italy	9.0
United Kingdom	6.0

Italy and the United Kingdom, on the other hand, are likely to slow down this year, as will several of the smaller European economies. In addition, in France,

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TABLE I

Forecasts: Gross National Product and Prices
(Annual rates, in percent)

		1984 Actual	*1985 Estimated*	*1986 Projected Median*	*1986 Projected Range*
Canada:	GNP	4.7	3.1	2.5	0.0 to 3.0
	CPI	4.3	4.1	4.5	3.8 to 6.1
France:	GNP	1.7	1.6	2.0	1.0 to 3.5
	CPI	7.4	6.0	5.5	4.5 to 8.0
Germany:	GNP	2.6	2.8	3.0	2.2 to 4.0
	CPI	2.4	2.5	2.5	1.5 to 3.6
Italy:	GNP	2.6	2.5	2.2	2.0 to 3.5
	CPI	10.8	9.0	9.0	6.5 to 11.0
Japan:	GNP	5.7	4.5	3.5	3.0 to 5.0
	CPI	2.3	2.5	2.5	1.5 to 3.7
United Kingdom:	GNP	1.6	3.1	2.4	1.5 to 4.5
	CPI	5.0	6.0	6.0	5.0 to 6.5

Germany and the Netherlands election campaigns will overshadow economic policy issues in 1986.

The fight against inflation has been more encouraging than efforts to stimulate growth, with the average annual inflation rate for the EC declining by over 6 percentage points between 1980 and 1984. A significant reduction in unit labor costs, plus the gradual decline of the dollar, are expected to lower the private consumption deflator from an average of 6.3 percent and 5.4 percent in 1984 and 1985, respectively, to 4.4 percent in 1986. Inflation rates are expected to decelerate in all member countries, except Italy and the United Kingdom, and should range from 2.0 percent in the Netherlands to 17.0 percent in Greece. Still, the overall decline in inflation in Europe is seen to be less than might have been expected given the considerable decline in the dollar that has already occurred.

Some Further Weakening of the Dollar

The majority of panelists expect a further, but gradual, weakening of the dollar against major currencies throughout 1986. The case for some additional weakening against the yen looks particularly strong, since the Japanese economy is expected to post one of the highest growth rates and the lowest inflation rate among the industrial countries.

But, according to the survey, the dollar's overall decline is projected as modest, with the dollar opening the year on a strong note, declining somewhat through much of the year, and then bottoming out toward year-end. An extreme view, not generally shared, sees a 20 percent decline against the D-mark and the French franc and a 15 percent drop against the British pound.

A trade-weighted depreciation between 5 and 10 percent in 1986, it was noted, would bring the dollar back to its average level of 1982 and, incidentally, just slightly below its value in 1971, before the demise of the fixed-rate system. All in all, the panel's exchange-rate projections for 1986 would not restore full international competitiveness to U.S. industry which, according to most economists working on the topic, would require a downward correction of around 25 percent from September 1985 levels.

But, one respondent remarked, the positive effects of the dollar decline in 1985 should not be shrugged off. Multinationals with large overseas operations—such as drug, personal-care, and computer companies—will now be able to report sizable

currency-translation gains. Simply put, their foreign earnings will be worth more to their shareholders.

The panelists felt that central-bank intervention to bring the dollar down, as agreed on at the end-of-September G-5 financial summit, could not guarantee an orderly major downward correction if the necessary reduction in the U.S. budget deficit was not brought about. In fact, because of uncertainties in intervention policy, U.S. budget policy, and U.S. business activity the dollar exchange rate itself will remain subject to uncertainty.

Yet, the panelists agreed, the timing of the G-5 meeting had been critical, since it was easier to push the dollar lower when it already was falling that when it was rising. Moreover, since the dollar already was weakening at the time, any rebound probably would be very modest. All in all, however, the readjustment of exchange rates is considered to be largely over for the time being.

Finally, it was pointed out, a lower dollar by itself does not induce faster growth abroad—it simply gives the authorities some leeway for more reflationary policies. Put differently, central-bank intervention can be useful in moving exchange rates in a more reasonable direction from the standpoint of achieving a better trade pattern. But it cannot take the place of appropriate domestic policies to maintain adequate economic expansion abroad.

Mixed Outlook for Major Industrial Countries

In forecasting economic activity and inflation rates for the six major industrial countries outside the United States in 1986, the panelists provided a fairly wide range of estimates—although, as pointed out, the midpoint projections for the six countries fall within a relatively narrow compass. Their qualitative comments discuss some of the fundamental factors in each country's performance.

Japan

Interest naturally focused on Japan, both because of the country's importance in the world economy and the sensitivity of U.S.-Japanese bilateral relations. Signs of weakness were detected in Japanese business, which was suffering its first drop in pretax profits in three years. Yet, capital expenditures remain healthy and are starting to be accompanied by a rise in personal consumption. The government also is reviving some large-scale construction projects left over from the previous administration.

Survey respondents feel that these expansionary trends and policies will be moderately effective, but that they cannot fully substitute for a drop in export earnings. In fact, while the government program announced in mid-October implies Japan's recognition of the need for expansionary measures, official claims of the program's impact on the economy in 1986 are considered exaggerated. Some of the proposed expenditures were already in effect; other measures merely bring spending forward from late 1986 or early 1987. The program's total impact is estimated to be no more than ½ percent of GNP, spread over two years, but concentrated in the first half of 1986. Moreover, some of the program's potential effects have been offset in part by the jump in Japanese interest rates in late October.

The Japanese economy is seen as remaining clearly outward oriented and dependent on international trade to realize its full potential. Flush with excess savings, state-of-the-art technology, and a thriving automobile industry, it cannot afford to do without a major export sector for long. Japan is resourceful enough, moreover, to look beyond the United States and Europe to China and other countries for its trading future.

The panel agrees that foreign tolerance of Japan's market penetration has come close to the breaking point. With the government taking steps to both restrain sales abroad and boost imports, business activity will have to rely more heavily on

domestic demand. But that takes time, and without the stimulus of expanding exports growth is bound to slow somewhat in 1986.

Germany

The 1986 outlook for Germany is generally characterized as "good" or even "strong". But these judgements merely make a comparison with 1985, when the economy grew by 2.8 percent. The projected growth of 3.0 percent or marginally higher is not remarkable by historical standards, nor is it sufficient to impart a much needed boost to Europe as a whole—although German officials appear to believe that their economy is booming. They feel, moreover, that it should not have to serve as a locomotive for the rest of the world.

The modest growth in 1986 is seen as being fueled mainly be private consumption as wage settlements are likely to be somewhat more generous than in 1985; a small cut in income taxes will benefit wage and salary recipients; and transfer payments will show a marked increase. A number of panelists, however, see an urgent need for a more ambitious reform of corporate taxes, aimed at removing distortions and creating a better investment climate. Some room for tax reduction, it is believed, might be found through a cut in government subsidies, which according to one recent estimate equaled 6½ percent of GNP and were available to numerous sectors, including agriculture, mining, aerospace, shipping and railroads.

Yet, the government has ruled out any radical tax reform during its term in office, but has chosen a two-step approach. The first stage, in 1986, includes a slight cut in personal income taxes, some preferential treatment for owner-occupied dwellings, increased family allowances, and easier access for small- and medium-sized businesses to risk capital. The second and somewhat more comprehensive part of the package is to be implemented in 1987-88, after the next general election.

This past October, the five leading German research institutes urged the government to advance the second stage to 1987. The government, however, shows no indication of following this recommendation.

France

The survey depicts France in a somewhat less favorable light than the country appears to deserve. There have been some notable improvements during 1985—in the inflation rate, in corporate profits, in productivity, and in the external accounts. In fact, by the year-end—just three months before the parliamentary election—economic prospects looked considerably brighter than they had for some time (survey responses, it must be noted, were prepared in the early fall).

Respondents tended to focus on the three years of austerity since Mitterand's Socialists came into office and stressed that the country was lagging behind its European neighbors in growth, while its inflation rate remained among the highest. Moreover, they pointed out, developments beyond the country's borders were now threatening to rob the economy of a major source of strength—exports.

Even a political realignment next March, it was felt, might not improve economic conditions immediately, since the need to contain inflation would keep government spending on a tight leash. One major impediment to faster growth that was cited is the rigidity of the overall regulatory environment; it remains difficult to shift human and physical capital from one use to another. In fact, as a manufacturing location France has the twin disadvantages of a relatively high labor cost base and relatively inflexible labor laws and price controls. A center-right majority next March would probably relax price controls somewhat; on the other hand, if inflation approached the ten-percent level controls might be tightened again, regardless of what party was in power.

Internationally, the French economy is too open and too much tied to the rest of Europe to be able to grow considerably faster than the European average. One

panel member predicts a 6 percent devaluation of the franc within the European Monetary System—even though the economic policy implications of a center-right victory in March would favor the franc.

Italy

In their outlook for Italy, the survey respondents display a tone of guarded optimism, even though in statistical terms they project somewhat lower growth in 1986. Panelists cite the apparent stability of the current government; a greater degree of common sense on the part of the trade unions; and a return to profitability in the corporate sector.

The panel concedes that inflation in Italy is still much higher than in the other industrial countries. But it notes that the inflation rate declined by four percentage points in 1984, another two points or so in 1985, and, barring a rise in the international price level, could decline to as low as 6-8 percent in 1986—arround current levels in Scandinavia.

Several panelists stress, however, that the economic picture is by no means all favorable. First, Italy has the largest government deficit among major industrial countries—equivalent to about 45 percent or more of revenues. The public debt itself is about the same size as the country's national income, and interest payments on the debt take up more than half of government spending. No long-lasting solution to this problem is seen forthcoming at this time.

Second, the trade deficit deteriorated rapidly in the first half of 1985 and, despite the devaluation of the lira within the EMS in July, the gap is expected to widen further. A larger trade deficit will increase the county's already high foreign debt and this, in turn, will weigh heavily on the balance-of-payments. Thus, the budget and the external situation are two dark spots on an otherwise slowly improving picture.

United Kingdom

In the United Kingdom, the government's autumn expenditures statement foresees three percent real growth in 1986, an inflation rate below four percent, a sizable rise in disposable income, and a balance-of-payments surplus of £4 billion (roughly $6 bill.) The panel members, as well as most other independent forecasters, are somewhat more pessimistic. They predict growth of around 2.5 percent (a figure also quoted by the Confederation of British Industry) and inflation of at least 4.5 percent, if not higher.

The official forecast assumes that consumer expenditures—which account for three-fifths of GNP—will rise by over four percent in real terms, as a result of income tax cuts in next March's budget, wage increases of between seven and eight percent, and a drop in consumer prices to 3.75 percent by the fourth quarter of the year.

The major difference between the government's and the panel's estimates concerns the rate of inflation. The official forecast assumes that unit labor costs will rise by no more than five percent (despite a seven to eight percent increase in earnings!) and that sterling will remain firm even if oil prices decline further.

The panel members also see slower growth ahead, in part because of the ending of accelerated depreciation allowances next March. As a result, capital spending is expected to rise by no more than two percent in 1986, as against the government's more optimistic four percent.

In addition, a few panelists feel that net exports in 1986 will be somewhat less buoyant, since their good showing in 1985 reflected the ending of the miners' strike and competitiveness gained from sterling's decline through 1984—factors that are not likely to recur in 1986.

On the plus side, panelists cite the government's policy goals of privatization and reduced financial aid to industry, which will make further progress over the next three years. With the government planning to raise $6.75 billion in each of the next three fiscal years from the sale of state-owned firms (as against $3.6 billion in the year ending in March 1986), it has been suggested that such sales might be treated as a form of covering official borrowing needs and thus relieve the budget.

Canada

Prospects for Canada are somewhat muted. The panel expects that GNP growth in 1986 will slow to 2.5 percent as major tax increases take effect. Significant increases in both personal income and consumption taxes will adversely affect consumer spending. Moreover, the increase in the Federal sales tax will boost the inflation rate to at least 4.2 percent.

Foreign investment in Canada is expected to remain sluggish until the authorities can convince foreign investors that the new "economic pragmatism" is for real. Moreover, panelists feel that the tax increases and spending cuts built into the 1986 budget can only serve to instill a more cautious attitude into foreign investors.

For the medium term, however, the free-trade negotiations between the United States and Canada are seen as a major opportunity for multinational corporations active in both markets as well as for new investors seeking a foothold in Canada. When officials from both sides resume informal meetings early in 1986, they will focus on a comprehensive arrangement that would phase out all remaining tariffs over ten years. Canada is expected to propose a joint body to arbitrate cases involving nontariff barriers. Eventual implementation of these arrangements, the panel concludes, will mean fewer impediments to the conduct of corporate operations across the border and provide a much more stable planning environment.

Other Countries

Some panelists provided projections for a few smaller industrial countries and some major developing ones. The basic contours of those projections are (1) a relatively better economic performance in some developing countries than in industrial ones, and (2) continuation of the "dual nature" of inflation in the developing world, with high rates in major Latin American debtor countries and much more moderate rates in some newly industrializing countries in Asia (Table 2).

TABLE 2

Selected Projections of GNP and Price Changes, 1986, for Smaller Industrial and Major Developing Countries (Annual rates, in percent)

	Real GNP	*Consumer Prices*		*Real GNP*	*Consumer Prices*
Australia	3.6	7.0	Argentina	−1.0	260.0
	3.0	6.5		0.0	200.0
Belgium	2.0	6.0	Brazil	3.0	200.0
	1.5	5.0		6.0	230.0
Netherlands	2.5	3.0	Hong Kong	4.5	5.5
	2.4	3.0		5.5	5.5
Spain	2.4	7.0	Korea	5.0	5.5
	3.2	6.5		5.0	4.5
Sweden	1.5	8.0	Mexico	3.0	60.0
	2.5	6.8		2.5	55.0
Switzerland	2.8	3.8	Taiwan	4.0	4.5
	2.0	3.0		5.5	3.0

Note: Each set of projections was supplied by one particular panel member.

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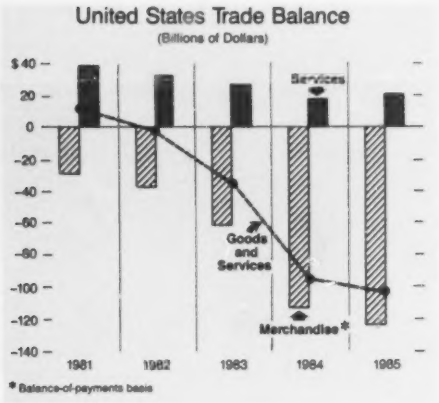
The Dollar and U.S. Trade



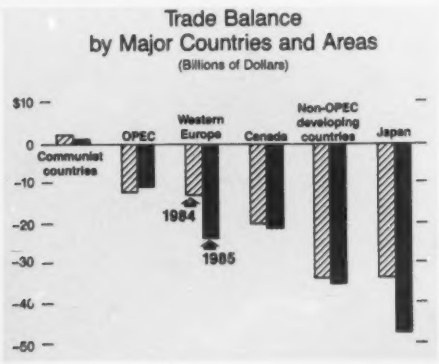
The U.S. dollar began to weaken against other major currencies in mid-March 1985. Its decline was given additional impetus by the late September meeting of the finance ministers of the five major industrial countries (G-5), at which they agreed that "some further orderly appreciation of the main nondollar currencies. . . is desirable." The five countries also stated their readiness "to cooperate more closely to encourage this when to do so would be helpful."

The sharp drop in oil prices this past winter put additional pressure on the dollar, both because it portended lower inflation rates and because the major oil-importing countries required fewer dollars to pay for oil imports. Overall, in the twelve months to mid-March of this year the dollar fell by 22 percent on a trade-weighted basis, i.e., against a composite of 15 other major currencies, and by 33 percent against the German mark and 32 percent against the Japanese yen.

At the same time, however, the foreign trade position and the overall balance of payments of the United States have shown no improvement. In fact, on both counts the 1985 performance was the worst on record. The merchandise trade deficit rose to $124 billion from $114 billion in 1984, while the deficit on goods and services (the broadest measure of the transfer of real resources between this country and the rest of the world) rose from $96 billion to $103 billion. The even more comprehensive current-account deficit—which measures the change in this country's international financial position—rose from $107 billion to $118 billion.

The rise in the 1985 trade deficit affected all merchandise categories, except petroleum, and all areas of the world, except OPEC. However, the different sectors and the various geographic areas shared unevenly in the deterioration of the U.S. trade position, especially when viewed over a five-year period.

The J-Curve Effect



Why have the U.S. trade and payments accounts not responded to the marked decline in the dollar? The relationship between changes in a country's exchange rate and its economy is complex at best. Exchange-rate movements, one student of the foreign exchange market has written, "bring about a chain of decisions by producers, consumers, and investors on whether to purchase foreign or domestic goods and whether to invest at home or abroad."

But generally there is a much simpler phenomenon at work: In the initial stages of a marked change in a country's exchange rate, the volume of both exports and imports fails to respond to that change. As a result, a trade deficit initially may become larger, even though the exchange rate has depreciated. This is what economists call the J-curve—an initial worsening followed, eventually, by an improvement. In other words, prices of exports and imports change more quickly than their volume, so that the value of exports may remain flat or even decline, while imports (priced in foreign currencies) would increase.

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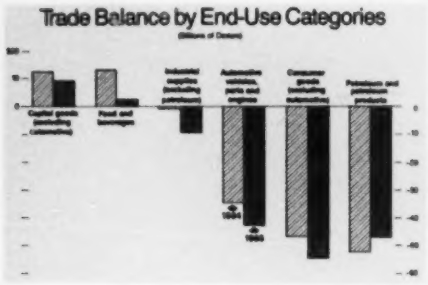
Special Factors at Work



Percentage Contributions to $137 Billion Deterioration in U.S. Non-Oil Trade Balance, 1980-85

By area: Africa, Australia and oceania	-0.7%
Canada	7.6
Western Hemisphere	12.7
Asia (excl. Japan)	22.4
Japan	26.4
Europe	31.6
	100.0
By major categories:	
Transportation equipment (excl. automotive)	2.5%
Chemicals	3.4
Crude materials	5.1
Agricultural commodities	11.3
Automotive vehicles	16.3
Miscellaneous products	16.4
Manufactures (excl. transportation and machinery)	16.7
Machinery	28.3
	100.0

The Dollar and Major Trading Partners

In the case of the United States, however, the trade picture is considerably more complex than can be explained in terms of exchange-rate relationships alone. Over the past few years, a good part of the deterioration in the U.S. trade position—some estimates put it as high as 50 percent—has reflected differences in the rates of economic growth between the United States and the other major industrial countries, the debt situation and hence the reduced import capacity of our major Latin American markets, and the greatly reduced financial clout and import potential of OPEC.

In the three years following the 1981-1982 recession (1983-85), the U.S. economy grew by 12.5 percent in real terms, compared with 5.5 percent for Western Europe. In addition, the onset of the economic recovery in the United States preceded the upturn in the other countries by approximately six months.

The Latin American debt crisis also had a pronounced effect on U.S. exports. Between 1978 and 1981, U.S. exports to Latin America had grown more than 50 percent faster than U.S. exports to the rest of the world, so that the declines of the early 1980's had a marked impact on overall U.S. export performance. The nearly $9 billion drop in U.S. sales to Latin America in 1982 accounted for over 40 percent of the total U.S. export decline that year. The 1983 drop of $7.4 billion was almost two-thirds of the total export decline of $11.7 billion. In both years, moreover, Latin America's imports from the United States fell faster than the decline in the area's imports from the world as a whole. (It should be noted that, following a further slight deterioration in 1984, the U.S. trade deficit with Latin America improved marginally last year, partly as a result of the major debtors' readjustment programs.)

OPEC's current-account balance declined from a record $110 billion surplus in 1980 to a deficit of $10-15 billion last year, as OPEC output came to account for an increasingly smaller share of total world oil production and as oil prices began to decline. While there are obvious differences in the financial positions of the various OPEC members (the so-called "low" and "high" absorbers), these developments affected overall OPEC purchases from the rest of the world. U.S. exports to that group fell from $16.9 billion in 1983 to $12.3 billion last year.

Another important aspect of the U.S. trade picture is the lack of any clearcut relationship between movements in the dollar and U.S. trade with individual countries. First, the largest bilateral deficits have not necessarily corresponded to exchange-rate movements vis-a-vis those countries. Second, much of our trade has been with countries whose exchange rates have moved little or even appreciated relative to the dollar over the past few years. In other words, a more detailed analysis of the geographic structure of the U.S. trade deficit during 1983-85 weakens the argument that the strength of the dollar was the major factor in our worsening trade performance.

Thus, Japan was the biggest single contributor to our global $300 billion deficit of those three years, its share amounting to $100 billion or one third. Yet, the dollar rose by only 7 percent against the yen during 1983-84 and then declined by 5 percent last year. (The corresponding relationships for Canada and Germany show even greater divergence.) Evidently, the dollar's strength had little to do with our huge trade deficit with Japan.

Exchange Rate Changes and U.S. Trade Shares

	Change in dollar rate, Feb. 1985 to Feb. 1986
South Africa	- 1.0%
Taiwan	- 0.3
Hong Kong	- 0.1
Canada	+ 2.6
Australia	+ 0.3
Korea	+ 4.9
China	+ 13.2
Philippines	+ 25.3
Chile	+ 38.5
Israel	+ 94.3
Mexico	+ 96.4
Brazil	+ 242.4

	U.S. exports (1985)	U.S. imports (1985)
South Africa	0.5%	0.6%
Taiwan	2.1	5.0
Hong Kong	1.3	5.0
Canada	22.4	19.3
Australia	2.5	0.8
Korea	2.8	2.9
China	1.7	1.2
Philippines	0.6	0.7
Chile	0.3	0.2
Israel	1.2	0.6
Mexico	6.4	5.3
Brazil	1.4	2.3
	43.2	41.4

Rather, Japan's trade surplus—not only with the United States, but with the rest of the world as well—is more a reflection of import barriers, relatively low domestic consumption, and superior product quality. (This is not to say that the United States is completely blameless in this matter. In an analysis of the U.S.-Japanese trade imbalance, the Committee for Economic Development last October cited "unbalanced macroeconomic policies" as well as "the inadequate performance by some components of the private sector" in both countries.)

The sharp drop in the price of oil—which in 1985 accounted for 31 percent of Japan's total import bill—will only tend to perpetuate, if not increase, that country's surplus. This year alone, Japan is expected to save an estimated $15 billion on its oil import bill. There has even been talk of Japan's becoming the "new OPEC" of the late 1980's, accumulating sizable external surpluses as oil prices decline further, but spending little of the additional savings abroad.

One further comment on the U.S.-Japanese trade relationship: Given the vast institutional and cultural differences between the two countries and their vastly different trade structures, completely balanced trade with Japan is not an objective that the United States can sensibly pursue. A recent study by the Washington-based Institute for International Economics has estimated what the bilateral trade deficit would have been if the U.S. budget deficit had not driven up both domestic interest rates and the dollar. The study finds that between 1980 and 1984 U.S. exports to Japan would have risen by more than 50 percent (instead of 12) and imports from Japan would have increased by only 50 percent (instead of 80). That still would have left a 1984 trade deficit of $23 billion, as against the actual $37 billion.

Second, the dollar's decline has been most marked vis-a-vis the European currencies and the yen—which eventually will help U.S. producers compete with Japanese and European exporters in third markets. Yet, a lower dollar has little impact on a dozen or so countries that account for over 40 percent of total U.S. trade, but against whose currencies the dollar either held its own or substantially appreciated in 1985.

The Role of Economic Policy

Some observers predict a further decline of 10 to 15 percent for the dollar in 1986, an amount considered necessary "to achieve a lasting balance" in our external accounts. But in view of the various factors mentioned here, such an improvement may be longer in coming and at the same time less marked than is generally hoped for.

Moreover, a reduction in the U.S. trade deficit cannot be achieved at the expense of the developing countries. As Morgan Guaranty put it recently, "Just as much U.S. government spending is off limits to budget cutters, many of the most significant U.S. trade partners either are in no financial position or are otherwise implausible candidates to cut back their sales to the United States."

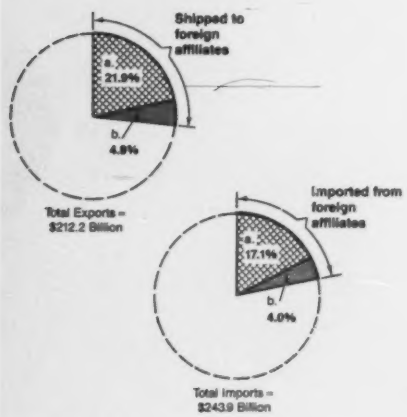
This means that most of the improvement in the U.S. trade position has to come vis-a-vis those countries that can most afford to reduce their own external surpluses. But when the imbalances, both domestic and international, have been allowed to get as large as they have over recent years, the necessary corrections, both in exchange rates and relative growth rates, may have to be substantial.

The United States appears to be living up to its responsibilities in this regard by recognizing the need to reduce its budget deficit and by adopting a more constructive and more realistic view of the role of exchange rates. But the needed corrections cannot be made by the United States alone; Europe has to play a major role as well. One would hope that the improved economic outlook and the heightened sense of optimism that prevail in Europe at this point will enable the European authorities to go for a somewhat more expansionary policy stance—which means to become more tolerant of some deterioration in their own comfortable external positions.

How Much Trade Is "Foreign" Today?

The entire debate over the U.S. trade performance tends to ignore one major development: In an increasingly internationalized and interdependent world economy the distinction between U.S. and foreign products is rapidly blurring. For example, over one third of total trade between the United States and Canada consists of automotive products moving between U.S. manufacturers and their Canadian subsidiaries. Again, the U.S. trade deficit with Taiwan was the third largest (after Canada and Japan) in both 1984 and 1985. Yet, four of the ten largest Taiwanese exporters are subsidiaries of U.S.-based companies, including such giants as RCA and Texas Instruments.

U.S. Trade with U.S. Companies' Foreign Affiliates, 1982



a. By U.S. parents
b. By other U.S. sources

In fact, an increasing share of U.S. trade takes place with the overseas affiliates of U.S. multinationals. In 1982, the year of the Commerce Department's latest benchmark survey of U.S. direct investment abroad, U.S. trade with such affiliates accounted for 26.7 percent of total exports and 21.1 percent of total imports. For trade between U.S. parents and their affiliates, the shares were 21.9 percent and 17.1 percent, respectively. For trade in manufactures alone, the ratios were roughly similar.

There is another dimension to the question of what constitutes trade or more properly "unfair" trade. This arises in connection with antidumping complaints filed by U.S. firms with the International Trade Commission (ITC). For instance, can the U.S. semiconductor industry claim to be injured by Japanese imports when many of the components it uses come from Japan? Or can a manufacturer who uses imported Brazilian steel which he rolls into pipes complain against imports of Brazilian steel pipe? On these and related aspects, both world trade law and, increasingly, the meaning of foreign-trade statistics don't seem to fit any longer the way in which U.S. companies do business.

As ITC chairwoman Paula Stern puts it: "It is possible that our laws, which are based on certain assumptions as to what 'U.S. industry' is, don't address the reality of the marketplace." This seems to become increasingly true for our trade statistics and hence for the perception of what our trade balance is and what it ideally ought to be as well.

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The Conference Board
70th Anniversary

World Economic Monitor

Volume 1, Number 3 Summer 1986

After The Tokyo Summit

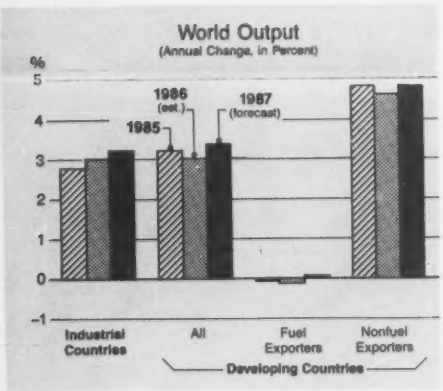
The twelfth economic summit meeting of the heads of government or state of the world's seven largest industrial countries, held in Tokyo this past May, has generally been hailed as a marked improvement over its eleven predecessors. For one thing, because of falling oil prices, the worldwide decline in interest rates, the ongoing realignment of exchange rates, the near-term outlook for the world economy was the most promising since the summits were launched in 1975.

More important, the Tokyo summit is considered an improvement over previous meetings because of the final communique's emphasis on "close and continuous coordination of economic policies among the seven summit countries." Specifically, the participants decided to form a new Group of Seven, consisting of their countries' finance ministers. The Seven would consult more closely and more frequently between the annual gatherings in order to exercise "multilateral surveillance" of each other's economies.

Output and Employment

What is the world economic outlook at the present time? It is true that lower oil prices and lower inflation and interest rates are providing the underpinning for continuing, albeit moderate, expansion in 1986 and 1987, or what the International Monetary Fund recently called "a consolidation in the pace of economic growth" (Chart 1). In the major industrial countries the demand components most likely to contribute to that expansion are consumer spending and fixed investment (Table 1).

Chart 1.



However, current projections offer little reason to anticipate another "golden age" for the world economy. In fact, the IMF's latest projections for the industrial countries differ little from those it presented a year ago or from its revised forecast of last October. The Organization for Economic Cooperation and Development, on the other hand, paints a slightly more cheerful picture in its mid-1986 outlook than it did at the end of last year. But the differences are slight and even the OECD sees the improved economic environment as adding no more than one percentage point to the industrial counties' gross national product by the middle of 1987.

One difficulty is that comparisons inevitably tend to be made with the 1960's when average annual growth in the OECD was some five percent. As Robert Lipsey of the National Bureau of Economic Research pointed out at the Conference Board's February 1986 Economic Forum, it seems to be common to take those years as the standard and consider anything less as slow growth. He feels it more appropriate to view the experience of the 1960's as an exceptional spurt, "exploiting a buildup of underutilized technologies or scientific advances that had accumulated during World War II."

A number of factors have a bearing on the near-term outlook. First, fiscal policy in the major countries is likely to be neutral, if not outright

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Table 1
Components of Real GNP Growth, Seven Summit Countries
(Percent change on previous year)

	1986	1987
Consumption expenditures	3.2	3.5
Fixed investment	5.0	4.5
Change in inventories	0.2	0.1
Government purchases	1.8	1.3
Domestic demand	3.5	3.5
Net exports	-0.4	0.0
Real GNP	3.1	3.5

less expansive. Second, a number of countries already have raised consumption taxes on gasoline and fuel oil, thus depriving consumers of the full benefit of the fall in oil prices. Third, industrial countries' exports are being affected by the reduced purchasing power of the major oil exporters. Finally, corporate profits remain well below earlier levels; according to OECD estimates, in 1985 average rates of return on capital in the major economies were barely above 1977-78 levels.

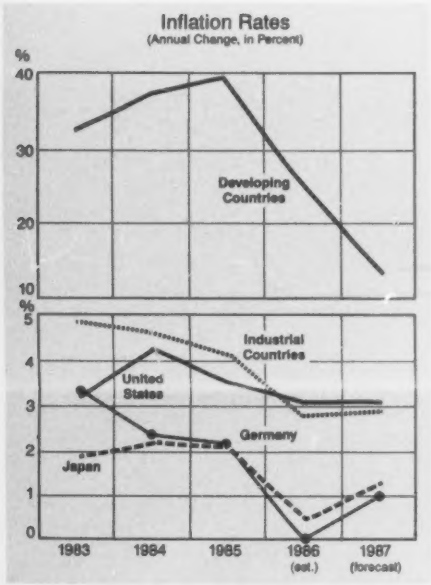
A moderate pace of world economic growth means that relatively little progress will be made in reducing the serious unemployment levels in many countries. In fact, in the absence of more rapid growth of output or of a slowing down in real wage growth employment creation is likely to remain limited.

For developing countries, growth prospects and living standards also are affected by population trends. According to recent IMF projections, per capita output in the developing world in 1986 will be virtually unchanged from the level at the beginning of the decade. This average conceals of course vast regional differences—output per head has risen considerably in Asia, but remains substantially lower than in 1980 in much of Africa and Latin America.

Inflation

In the industrial countries, inflation rates have been declining during the current expansion in economic activity and both IMF and OECD projections call for a further decline this year (Chart 2). Apart from the drop in oil prices, factors that will tend to keep inflation rates relatively low include fairly cautious monetary policies, moderate wage increases, deregulation of various markets, heightened international competition, and continued weakness in commodity prices.

Chart 2



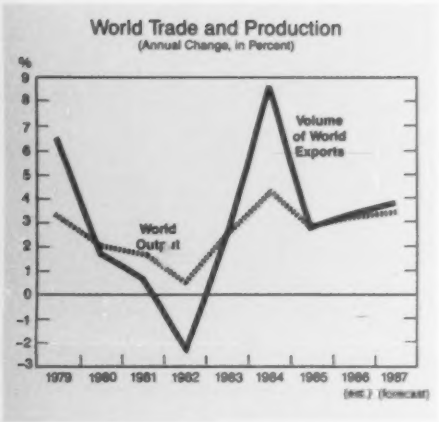
For the seven summit countries combined, the annual inflation rate during the first quarter of 1986 fell to 3.2 percent, the lowest since 1967. This contrasts with a peak of almost 14 percent in the first half of 1980. Much lower inflation rates were achieved by individual countries: In Germany, prices fell by 0.1 percent in the year through April and in Japan, they rose by 1.1 percent in the twelve months through March. Considerable progress has also been made in countries with traditionally high inflation rates. In France, the consumer price index fell from almost 6.5 percent in mid-1985 to 3 percent last March, while in Italy inflation receded to single digits in 1985 for the first time since the early 1970's.

The weighted inflation average for the developing countries—close to 40 percent in 1985—is misleading because it includes a handful of countries with triple-digit inflation. The median rate of inflation, which disregards such extreme cases, declined from 14.5 percent in 1980 to 9 percent in 1985. It is expected to remain in that range this year and fall even further in 1987.

World Trade and Payments

World trade has been one weak element in the overall economic picture. In the spring of 1985, the IMF had estimated that world production and trade would grow by 3.4 percent and 5.4 percent, respectively, last year. Yet, trade volume increased only by 2.9 percent or by no more than world output (Chart 3). Last year's weakness in trade can be attributed in part to the significant slowdown in economic activity in the industrial countries, which in turn affected adversely the exports of the developing countries. In addition, with the marked decline in oil prices the major oil producers cut back their imports more sharply than had been anticipated.

Chart 3.



Both the IMF and the GATT see last year's slowdown in trade only as a pause. In line with their projections for economic activity in the industrial countries in 1986, both organizations expect that world trade will show an increase of between three and four percent both this year and in 1987.

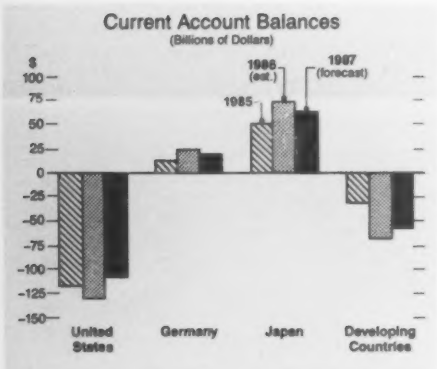
The overall payments imbalances of the major industrial countries are likely to widen further this year. Despite the narrowing of the U.S. trade deficit in April, a noticeable improvement in the U.S. trade accounts is not expected soon and the 1986 current-account deficit will even be slightly higher than in 1985. The current account surpluses of Germany and Japan will actually increase this year, reflecting the combination of lower prices for oil and other import commodities and the lower dollar (Chart 4).

At an oil price of $15 a barrel, the current-account balances of the United States, Germany and Japan would benefit by $20 billion, $18 billion, and $9 billion respectively, assuming oil imports remained unchanged from 1985 (Table 2). However, these cuts in their import bills represent a larger percent of GNP for Germany and Japan than for the United States.

Coordinating Policy

In this not very buoyant and even somewhat uncertain economic environment, the provisions of the Tokyo agreement bear close watching. In addition to setting up the Group of Seven, the participants also agreed to monitor each country's progress against a range of basic indicators, from inflation rates to growth. In case of "significant deviations" from those projections the seven countries' finance ministers and central bankers would "make their best efforts to reach an understanding on appropriate remedial measures."

Chart 4.



Better coordination of national economic policies has been a goal, either declared or unstated, of the summits since their inception. While each country's basic aims, such as satisfactory levels of growth and employment, have never been questioned, fundamental differences continue to exist on how these and related goals can best be attained. This helps explain not only the divergence in countries' actual performances, but also the inability of the summit participants to agree on what an ideal policy mix might or should be.

Even scholars and government officials have some difficulty in agreeing on what policy coordination or its less formal cousin, harmonization, really means. Thus, John Williamson of the Washington-based Institute for International Economics feels that "coordination should strive for. . .a set of mutually consistent policies on the part of individual countries which. . .collectively add up to an outcome that is satisfactory for the world as a whole." Robert Roosa, of Brown Brothers Harriman and a former Undersecretary of the Treasury, prefers the term harmonization, which he defines as "a conscious effort to work toward programs that will have harmonious rather than divisive effects in the relations among their key countries."

Making Coordination Work

Table 2
Current-Account Effect of Lower Oil Prices
($ billion)

	Per Barrel Price $15	$10
United States	-20	-28
Japan	-18	-25
Germany	-0.9	-13
France	- 7.5	-10
Italy	- 6.5	- 9

There are of course formidable difficulties in coordinating the various national policies—or even in comparing their goals and impact. There are, for instance, vast differences among countries in the conduct and targets of their monetary policies, including the various definitions of money supply. In addition, each county differs in how much attention it pays to interest-rate levels and short-term interest-rate movements, as well as in its attitude toward the relation ship between monetary policy and the exchange rate.

Similar difficulties attach to making meaningful comparisons between the major countries' fiscal policies. The most important difference among the seven summit countries concerns the relative roles of regional and local governments and of public enterprises—and hence the fiscal relations between those units and the central government. There also are major differences in the scale of government lending to both private and public enterprises, leading to differing borrowing needs by the central government and differing pressures on private financial markets.

As to the specific indicators listed in the Tokyo communique, who is to decide what particular targets are appropriate for a given country? And how can countries be brought back into line once their indicators begin flashing red? After the Williamsburg summit in 1983, Donald Regan, then Secretary of the Treasury, quipped, "If somebody is out of step, you say so."

But the communique contains no hint that any government might have to adopt a policy it would not have adopted anyway or that other countries might expect it to adopt. Moreover, both Germany and Japan already have strenuously objected to U.S. suggestions that they should stimulate their economies at this point in order to act as the world economy's locomotives, simply because their indicators (by U.S. standards, at least) were pointing in that direction. Just days before the Tokyo meeting, Germany's five leading economic research institutes urged the authorities not to bow to U.S. pressure.

It can be argued that last September's Plaza Accord to drive down the value of the dollar revealed a unique identity of interests. This was followed by "coordinated" discount rate reductions in early March (Germany, Japan and United States) and late April (Japan and United States). But in mid-1986 it is less apparent that a similar identity of interests among the major economies exists.

The best that might therefore be expected at this particular time is an awareness of the problems other countries are facing and of how they are tackling them. As Paul McCracken, a former chairman of the Council of Economic Advisers, noted recently, "Managing policies at home is presumably done a little more intelligently with some idea about the policy strategy of other governments."

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The Conference Board
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World Economic Monitor

Volume 1, Number 4 Fall 1986

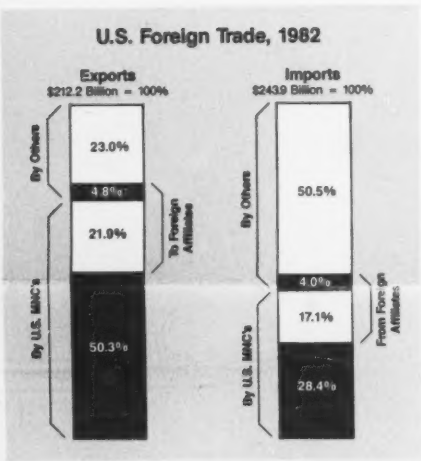
The Intracompany Trade of U.S. Multinationals

Can intracompany trade—that is, trade between a multinational corporation (MNC) and its foreign affiliates—be considered genuine foreign trade? More important, are intracompany transactions guided by different considerations and do they respond differently to economic forces than trade with unaffiliated parties? Interest in these issues has been growing as somewhat more detailed data have become available and as more and more corporations, from both the United States and other industrial countries, have set up manufacturing facilities in generally lower-cost locations abroad.

Multinationals and U.S. Trade

While it is clear that MNCs play a considerable role in international trade, it is not easy to quantify that role. As a recent United Nations report noted, "Unfortunately, comprehensive data on the foreign trade of transnational corporations exist only for the United States." For example, *Fortune's* annual listing of the 50 largest U.S. exporters shows that the top 15 firms on the list account for almost 20 percent of total U.S. exports and almost 30 percent of exports of manufactures. The entire group of 50 companies provides roughly 30 percent of total and 45 percent of manufactures exports.

Chart 1



MNCs likewise account for a large share of U.S. imports. But only part of their total trade is with their overseas affiliates. In 1982 (the year of the Commerce Department's latest benchmark survey of foreign direct investment), U.S. MNCs provided 72 percent of total U.S. exports, but less than one third of these shipments went to their affiliates (Chart 1). On the import side, U.S. MNCs took 46 percent of the U.S. total, with slightly over one third shipped by their overseas affiliates.

The international orientation of U.S. MNCs is confirmed by the fact that their 1982 share of total exports (72 percent) was considerably larger than their share of U.S. business (25 percent of total nonbank employment). This probably reflected their concentration in goods-producing sectors, as well as their greater ability to adapt their production rapidly to the needs of their foreign customers. But it also indicated their close links with their foreign operations, since over half of U.S. parents' shipments to majority-owned foreign affiliates was intended for further manufacture.

All these data cover only trade between U.S. MNCs and their overseas affiliates. If the U.S. affiliates of **foreign** MNCs are included (these are part of "others" in Chart), the share of U.S. trade generated by **all** MNCs, both U.S. and foreign-based, is much higher and in 1982 accounted for 94 percent of all U.S. foreign trade (Table 1). This was split approximately two-thirds/one-third between U.S. MNCs and the U.S. affiliates of foreign MNCs (Chart 2).

A more recent survey by the Federal Reserve Bank of Boston confirmed the prevalence of intracompany trade. Responses by 57 New England

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Table 1
U.S. Foreign Trade Associated With MNCs*

	Amount ($ bill.)		Share (percent)	
	1977	1982	1977	1982
Total U.S. trade (exports plus imports)	278.7	456.1	100.0	100.0
MNC-associated trade of which:	254.0	428.7	91.1	94.0
With unaffiliated parties	149.0	263.9	53.4	57.9
Intracompany	105.0	164.8	37.7	36.1

*U.S. MNCs plus U.S. affiliates of foreign MNCs

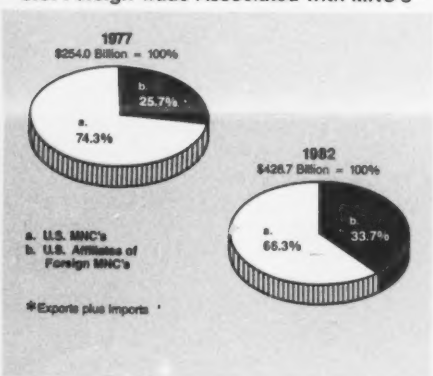
MNCs (18 foreign-owned affiliates and 39 U.S. firms) indicated that in 1983 over half of the firms' foreign trade was in-house. Intracompany exports and imports averaged 50 and 58 percent, respectively, of the U.S. respondents' total trade. For the U.S. affiliates, 44 percent of exports and 70 percent of imports were with their foreign parents.

The data also showed that between 1979 and 1983 the U.S. parents' trade with their two largest affiliates grew much faster than their trade with the two countries in which the affiliates were located. Exports to the two most important affiliates rose by 35 percent as against only 19 percent in overall shipments to the host countries. Imports from major affiliates surged by 279 percent over the same period, as against 56 percent for all imports from those same countries. The survey notes, however, that many of the affiliates in question were established since the late 1970's and that their trade therefore expanded from relatively low levels.

The Role of Intracompany Trade

Chart 2

U.S. Foreign Trade Associated with MNC's*



While the data on intracompany trade always are several years old, they do provide a general outline and suggest that for some industries, as well as for individual countries, such trade can be significant. On a geographic basis, the data are fairly easy to interpret. Thus, in 1982 shipments by Canadian affiliates to their U.S. parents (mainly in the automotive sector) accounted for 36 percent, and those of British affiliates for 9 percent, of their countries' exports to the United States. Intracompany shipments by U.S. affiliates in Hong Kong, Singapore and the Caribbean contributed 15, 56 and 64 percent, respectively, to U.S. imports from those areas.

On an industry or product basis, the picture is more muddied since the published data show MNC-associated exports and imports by **industry** of the parent, rather than by product. Some product detail is available for exports to and imports from majority-owned foreign affiliates—but even then the tables have considerable gaps "to avoid disclosure of data of individual companies."

But the industry of the parent may not reflect precisely the products that are exported, since U.S. MNCs tend to be highly diversified and hence may deal in products outside the major industry under which they are classified. They also may export goods purchased domestically outside their own industry and then shipped abroad. Similarily—although probably to a smaller extent—the industry of the U.S. parent does not necessarily indicate the nature of the products it imports.

With these caveats in mind, the **industry** data show that in 1982 imports from affiliates by the industrial chemicals, nonelectrical equipment, and

printing sectors equaled 15-20 percent of total U.S. imports of industrial chemicals, etc.; for the office machines and computer sector, intracompany imports equaled 30 percent of U.S. imports of office equipment. On a **product** basis, petroleum and petroleum products and vehicles and parts accounted for over half of all imports from majority-owned foreign affiliates (Table 2).

Table 2
U.S. Imports From Majority-Owned Affiliates, 1982

By industry of affiliate:	
Petroleum	33.5%
Transportation equipment	26.5
Electric and electronic equipment	11.7
Nonelectrical machinery	5.7
Wholesale trade	5.6
Chemicals	4.2
All other	12.8
	100.0
By product:	
Petroleum and petroleum products	33.3%
Road vehicles and parts	23.9
Machinery	20.0
Crude materials	4.5
Chemicals	4.2
Metal manufactures	3.3
All other	10.8
	100.0

It would be interesting and instructive to obtain intracompany data for individual companies, but such information surfaces only occasionally among the financial statements in annual reports. Thus, Digital Equipment Corporation, with total 1985 sales of $6.7 billion, showed intracompany sales, both in the United States and abroad, of $1.9 billion (29 percent). However, such sales accounted for 82 percent of the company's sales to customers in Canada, the Far East, and Latin America.

Can in-house trade be considered foreign trade in the traditional sense of that term? It is foreign trade for strictly statistical purposes, since it involves shipment of goods across national frontiers. But beyond the shipment itself, does an intracompany export "earn" dollars for the United States? Conversely, does importation of a part or component from an overseas manufacturing facility lead to an additional accumulation of dollars by "foreigners"? If, for argument's sake, during a given month all U.S. trade were in-house, by how much would that month's trade balance really be in the red? To answer these and related questions calls for a more detailed study of MNCs' internal accounting and payments practices.

Factors in Intracompany Trade

Does intracompany trade march to a different drummer than trade with unaffiliated parties? It has been argued that the trade of MNCs with large investments in several countries may not respond as rapidly to price shifts as the trade of independent producers that do not have to be concerned with the effect of their actions on affiliates' profitability. An MNC may divide the world market for a given product into distinct areas and allocate specific markets to different affiliates.

Another reason cited for the allegedly lower price responsiveness of intracompany trade is that closely integrated affiliates produce goods tailored to the parent's particular manufacturing and distribution needs. Such goods tend to have fewer close substitutes than the more standardized items purchased from unaffiliated suppliers and thus would be less responsive to price changes.

Under this view, intracompany trade tends to be fairly prevalent in technology-intensive industries, which have a greater need for inputs with highly specialized characteristics. Thus, in a survey of the world's 800 largest MNCs, a British researcher found that, while about one-third of these firms' 1983 trade was in-house, among high-tech firms such trade averaged 43 percent, as against a 13 percent average among low-tech firms. The example of Digital Equipment, given above, confirms these findings.

On the other hand, intracompany trade is largely "managed" trade that enhances an MNC's flexibility, permitting it to shift production between parent and subsidiaries quite rapidly. Intracompany trade might therefore be expected to be more sensitive to macroeconomic factors, such as relative price movements.

The Boston Fed's survey did in fact find such reactions. A number of the U.S. respondents indicated that they did or would move production abroad because of the dollar's appreciation. As noted, the respondents' intracompany imports grew much faster than their total imports as the dollar continued to appreciate.

The survey results even suggest that the growth in U.S. MNCs' intracompany trade may have aggravated the U.S. trade deficit in recent years. However, by expanding foreign production and intracompany imports, MNCs may have been able to maintain a larger volume of domestic output and sales than if they had not been operating abroad.

MNCs and Trade Policy

U.S. MNCs have been important in fighting major pieces of protectionist legislation. For example, they were decisive in turning back the Burke-Hartke bill of 1972 (which would have imposed quantitative import restrictions and imposed stringent controls on foreign investment). They likewise resisted repeal of those sections of the Tariff Schedule that permit duty-free re-entry of inputs that originated in the United States and hence are ideally suited to multinational production.

In fact, both the level and trend of U.S. import protection appear to be somewhat more liberal for goods in which intracompany trade is substantial. Industries that enjoy significant protection, such as textiles, apparel, leather footwear, and dairy products, or that are given intermittent relief, such as steel, are notably nonmultinational. The case of the orderly marketing agreement for Japanese color television sets is interesting in this respect, since similar agreements were not negotiated with other countries such as Mexico and Korea, where U.S. affiliates are heavily represented.

Thus, the overseas activities of U.S. MNCs may have a marked bearing on which particular products or which particular suppliers are affected by import barriers. There may in fact be a growing disparity between what the Boston Fed survey calls the "haves" and the "have-nots" among U.S. firms. Those without foreign affiliates will be petitioning for additional import restraints, while those with affiliates will clamor instead for greater access to foreign markets.

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The Conference Board

Economic Analysis Program

World Economic Monitor

Volume 2, Number 1 **Winter 1987**

INTERNATIONAL OUTLOOK 1987

Economists make predictions not because they know, but because they are asked.

John Kenneth Galbraith in *The New York Times*, November 23, 1986

Members of The Conference Board's Economic Forum, meeting in mid-November, were pretty much in agreement that the outlook for the U.S. economy in 1987 would be "more of the same"—namely, a continued, if none too spectacular, advance in overall economic activity and continuation of present levels of inflation and interest rates.

With the United States accounting for about one-quarter of global output, the 1987 prospects for the rest of the world are largely similar:

- Economic growth, in both the industrial and the developing countries, will be somewhat—but not much—better than in 1986.
- Inflation is expected to remain subdued in the industrial countries, largely as a result of lower oil and commodity prices, and to recede somewhat in the developing countries.
- The volume of world trade is likely to register a slight decline, while recent exchange-rate shifts are expected to reduce the major industrial countries' external imbalances somewhat.

Modest Growth in 1987

The outlook for the major industrial countries for 1987 is for only modest growth over 1986—and for several of them lower growth rates than in 1985 (Table 1). The latest economic forecasts for 1987, both by official organizations and by corporate economists, incorporate downward revisions from projections made earlier in 1986. These adjustments reflect the rather disappointing results of the first half of 1986 in the industrial countries and weaker prospects for the export earnings of the developing countries. Indeed, by last summer earlier arguments for a fairly strong world economic performance in 1987 no longer appeared convincing. Ironically, it is the admittedly slim improvement in the 1987 outlook for the oil-producing countries, because of the recent firming of oil prices, that provides the bulk of what improvement is foreseen for the world economy as a whole (Chart 1).

Chart 1

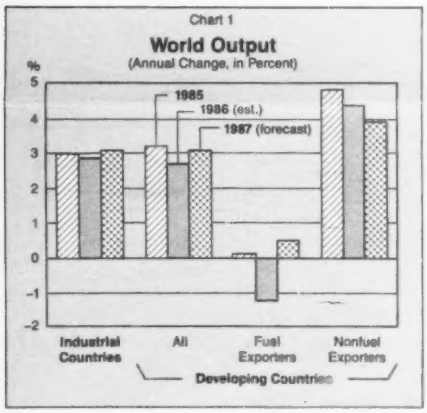

Table 1

Gross National Product, Major Industrial Countries
(Annual changes, in percent)

	1985 Actual	*1986 Estimated*	*1987 Projected Range*
Canada	4.0	3.3	2.8 - 3.6
France	1.3	2.2	2.0 - 3.0
Germany	2.5	3.0	2.5 - 3.8
Italy	2.3	2.8	2.5 - 3.8
Japan	4.5	2.6	1.5 - 3.5
United Kingdom	3.3	2.4	2.0 - 3.0
United States	2.7	2.7	1.4 - 3.5

Sources: 1985 and 1986: International Monetary Fund. 1987: International Monetary Fund, Commission of the European Communities, Barclays Bank, Banque Paribas, Swiss Bank Corporation, Merrill Lynch, U.S. corporate estimates.

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During the second half of 1986 two elements of potential weakness were emerging. First, in the major industrial countries outside the United States exports were beginning to make a smaller contribution to overall output than they had in the mid-1980s. Second, while last year's sharp decline in oil prices had generally been hailed as potential stimulus to global economic activity, it soon became clear that the negative effects of the price drop on the oil and oil-related industries in the industrial countries initially were outweighing any positive effects on consumer incomes.

The question now is not whether the effects of lower oil prices on consumer spending—reinforced outside the United States by the drop in the dollar—have merely been delayed, but whether they will provide a major boost at all. In fact, energy prices paid by consumers in the major industrial countries have by no means fallen by as much as had been anticipated, partly because of higher energy taxes. As against a decline of some 55 percent in spot oil prices by last summer, local prices paid by domestic consumers in major countries had generally fallen by much less (Table 2).

Table 2

Decline in Oil Product Prices
July 1985-July 1986
(Percent changes, in national currencies)

	Gasoline	*Heating Oil*
Italy	- 4.8%	-18.6%
Japan	-11.7	-12.8
France	-16.1	-44.0
United Kingdom	-18.2	-39.6
Germany	-26.2	-58.9
United States	-29.0	-35.1

It also is worth noting that over the past year the industrial countries have benefited from sizable gains in their terms of trade as prices of manufactured goods have risen relative to the price of oil and nonoil commodities. But there is little evidence that these countries have attempted to stimulate their own economies sufficiently to offset the corresponding deterioration in the purchasing power of the developing countries. According to calculations by Barclays Bank, demand growth in 1987 in the seven major industrial countries (the so-called Group of Seven) will exceed the growth of actual output in the seven by just over 0.4 percent, compared with 1.0 percent in 1986. Thus, the stimulus provided to the developing world by industrial country demand will be substantially less than last year.

The European Community

Despite the common experience of lower oil prices and the depreciation of the dollar, the member countries of the European Community (EC) will follow differing growth patterns in 1987. The two major energy producers—the Netherlands and the United Kingdom—are expected to experience a slight slowdown of their economies. Certain other countries with large public-sector deficits and sizable external deficits have adopted various restraint measures, whose impact may more than offset the effects of lower oil prices and of the lower dollar. This is especially true for Greece and, to a lesser extent, for Belgium and Denmark.

In addition—and in some cases as part of budgetary corrections—a number of countries have recently raised energy taxes or the official prices charged for various energy products. These countries include Spain, Portugal, Greece, Italy, Ireland and Denmark.

Looking to 1987, the projected growth rates for the members of the EC range between -0.2 percent (Greece) and 3.6 percent (Portugal). As regards individual countries, the European Commission predicts that Germany, Ireland, Italy and Portugal will experience growth rates above the projected EC average of 2.8 percent; France and Spain will grow at about the EC average; the British economy will be slightly below the average; and the Benelux countries and Denmark will not be able to grow by much above 2 percent.

The Commission is at pains to point out that, while the 1987 outlook may represent an improvement over recent years, it still remains below the rates "necessary for a significant and durable reduction in unemployment."

Japan

On the basis of current projections, there is little reason to expect much of a pickup in economic activity in Japan in 1987. This is true even in the face of the discount rate cut and the comprehensive tax reform package

announced at the end of October. The rate cut is mostly symbolic and unlikely to have much of a stimulating effect, largely because the discount rate is not indicative of domestic borrowing costs. The effects of the proposed tax reform would make themselves felt only some years from now—and then only if the various parts of the package succeeded in boosting domestic investment and consumption.

With the ye[illegible]pected to remain firm and the effects of its appreciation to date still to be translated completely into altered trade patterns, those sectors of the Japanese economy exposed to foreign competition will continue to weaken.

Inflation To Remain Moderate

Inflation prospects for 1987 look fairly promising. In the industrial countries, increases in the consumer price index are expected to remain quite moderate. For those countries as a group, the CPI is projected to rise by 3.0 percent, as compared to 2.2 percent last year. In Germany and Japan, the price level is expected to remain virtually unchanged (Table 3). This relatively good inflation picture, the best in two decades, owes much to declining oil and commodity prices and to the effects of appreciating exchange rates for the major currencies. As these effects begin to weaken, inflation may well pick up again somewhat. However, the underlying inflation rate, as measured by the GNP deflator, is actually expected to be somewhat lower in 1987 than last year.

Chart 2

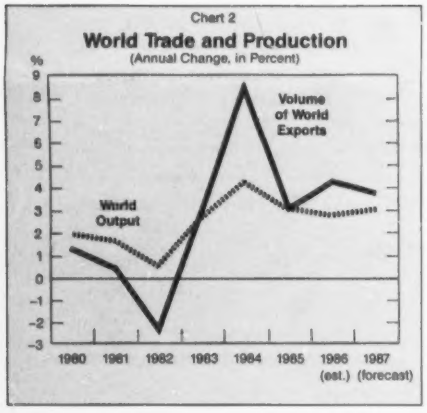

Table 3

Consumer Price Index, Major Industrial Countries
(Annual changes, in percent)

	1985 Actual	*1986 Estimated*	*1987 Projected Range*
Canada	4.0	4.2	3.5 - 4.5
France	5.8	2.7	2.2 - 3.0
Germany	2.2	-0.2	0.5 - 1.5
Italy	9.2	6.0	4.8 - 6.0
Japan	2.1	0.5	-0.2 - 1.2
United Kingdom	5.7	4.2	3.0 - 4.0

Sources: 1985 and 1986: International Monetary Fund. 1987: International Monetary Fund, Commission of the European Communities, Barclays Bank, Banque Paribas, Swiss Bank Corporation, Merrill Lynch, U.S. corporate estimates.

For the developing countries, inflation rates are seen as receding considerably, largely because of recent successes, in a number of previously high-inflation countries, in breaking the inflationary spiral. Thus, for four of those countries—Argentina, Bolivia, Brazil and Israel—the composite inflation rate is projected to drop from over 300 percent in 1985 to 119 percent in 1986.

This particular phenomenon is largely responsible for the projected decline in the average inflation rate for all developing countries, from about 40 percent in 1985 to 28 percent in 1986 and 16 percent this year. Even for the fifteen largest debtor countries, average inflation is expected to fall from 123 percent in 1985 to 77 and 32 percent in 1986 and 1987, respectively.

Smaller External Imbalances

The conclusion that the industrial countries "may not be doing enough" to boost global demand is reinforced by their balance-of-payments experience. The combined current-account surplus of the industrial countries outside the United States is expected to improve dramatically, from $64 billion in 1985 to $123 billion in 1986 (Table 4). A small deterioration, to a surplus of $110 billion, is projected for 1987, when the 1985-1986 exchange-rate shifts should begin to affect trade volume (Chart 2). But the improvement over the 1985-87 period suggests that demand in the major industrial countries will not have expanded sufficiently to offset the adverse effects of the decline in commodity prices on the rest of the world.

Table 4

Current-Account Balances
(Billions of dollars)

	1985 Actual	1986 Estimated	1987 Projected
Industrial countries	-53.5	0.0	-11.6
Industrial countries, excl. United States	64.2	123.0	111.4
Germany	13.3	30.8	25.5
Japan	49.2	82.7	74.1
Developing countries	-19.0	-57.6	-46.5
Fuel exporters	4.3	-38.9	-24.0
Nonfuel exporters	-23.3	-18.7	-22.5

Within the group of industrial countries, a significant feature of the outlook for both 1986 and 1987 is continuation of a current-account deficit of over $120 billion for the United States, as well as the persistence of sizable surpluses for both Germany and Japan. (The figures for Germany and Japan are somewhat misleading, however, since they are in dollar terms and hence are inflated by the recent depreciation of the dollar.) Expressed as a percentage of gross national product—which is considered a more satisfactory measure of external balance—IMF projections indicate that the U.S. payments deficit should decline from 2.9 percent of GNP in 1985 to 2.7 percent in 1987. Germany's surplus is projected to rise from 2.1 percent of GNP in 1985 to 3.4 percent in 1986 and then drop to the equivalent of 2.5 percent in 1987. For Japan, a projected rise from 3.7 percent of GNP in 1985 to 4.1 percent in 1986 is expected to be followed by a relatively sharp drop to 3.3 percent this year, as the effects of the yen appreciation are beginning to be fully felt.

These modest reductions in the payments imbalances of the three largest industrial countries, although welcome, seem to imply that that the exchange-rate shifts that have occurred since the first quarter of 1985 may not be sufficient by themselves to make the three countries' current-account positions more sustainable from here on.

Improved Policy Coordination?

With the external imbalances of the major countries expected to remain relatively large, the question naturally arises whether better coordination of national economic policies could play a role in moving toward a more sustainable external equilibrium. Most European policymakers would argue that, to judge by the 1987 outlook for their countries, there really is no growth problem for Europe and therefore no need for Europe to try and "grow harder."

The various U.S. suggestions that the Europeans stimulate their economies by monetary and/or fiscal measures, both to prop up the world economy and help reduce the U.S. payments deficit, reflect what Swiss Bank Corporation recently labeled "a sort of Pavlovian response"—that is, the belief that changes in one part of an economic system will result in definite and controllable changes in another. The Europeans are not quite as sanguine on that score.

While European policymakers agree that surplus countries have their part to play in reducing global payments imbalances, they do feel that, by their own standards, growth prospects are relatively encouraging and that the forces working in that direction do not need to be reinforced by policy measures. Moreover, they do not buy the argument that a more expansionary policy stance would lead to much additional growth in imports—and still less to measurable growth in imports of U.S. products.

U.S. attempts to influence other countries' policy directions fall under the much vaunted rubric of "international economic policy coordination." But as recent events have made amply clear, coordination—which would imply a significant modification of national policies in recognition of international economic interdependence—may very well be a dead letter. Bilateral cooperation, such as the recent U.S.-Japan accord involving a discount rate cut and a broadly based tax reform by Japan, may be more appropriate and at the same time more acceptable to deal with policy differences as they arise.

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THE DOLLAR AND U.S. TRADE

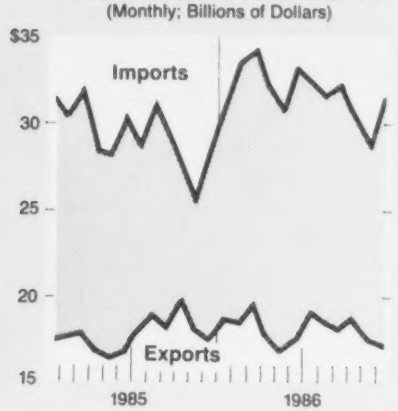
The exchange rate of the dollar against most other major currencies has been declining more or less steadily since early 1985. Relative to the German mark and the Japanese yen, the dollar's decline has been unmatched by any major currency during the post-World War II period. At the same time—and against all predictions—the U.S. trade deficit has stubbornly refused to shrink.

Over the past two years, the trade deficit has failed to narrow, whether on an overall basis (Chart 1) or in terms of our major trading partners. The bilateral deficit with Japan alone, for example, accounted for over one-third of the total 1986 deficit. While the most recent data can be interpreted as suggesting that the trade balance is no longer worsening, clear evidence of an actual turnaround has yet to emerge. On the other hand, German and Japanese exports have already suffered because of the sharp appreciation of the mark and the yen.

Chart 1

United States Trade Balance

(Monthly; Billions of Dollars)



More important, when measured in *constant* dollars—which form one of the key components of the U.S. national accounts—exports in 1986 showed much smaller gains than imports (Chart 2). For the year as a whole, exports of agricultural products in constant dollars were unchanged from 1985; those of nonagricultural products were up by some $10 billion; and imports of nonpetroleum products were up by $35 billion. As a result, almost one-third of last year's increase in domestic demand leaked abroad through the deterioration in the U.S. trade position and reduced the growth of GNP accordingly. However, this trend appears to have been reversed toward the end of 1986.

Is there an inherent contradiction between the behavior of the dollar and that of the trade figures? Ought there to be greater correspondence between the two? Or are we looking at two largely independent phenomena, at numbers that are related much less than we have tended to assume?

The Nature of U.S. Trade Data

The nature of the monthly trade data is such that they bear little resemblance to a given month's actual trade and even less to the dollars earned by foreign suppliers. The import data, moreover, tend to overstate what we "owe" foreigners, so that it is incorrect to draw firm conclusions for the dollar from the monthly figures.

The monthly trade data that are eagerly awaited and then linked to that day's movements in the dollar—a typical headline might read "Dollar Higher on Better Trade Figures"—are based on a somewhat artificial statistical construct. These numbers—the trade data—reflect neither the actual movement of goods into and out of the United States nor payments for exports and imports. The connection between a given month's trade deficit and what we "owe" foreigners because of that deficit is therefore rather tenuous. So are the implications for the dollar's level.

What do the trade figures actually reflect? The Census Bureau's monthly merchandise trade statistics are obtained from shippers' export declarations and from import entry forms filed with Customs. The pub-

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Chart 2
Merchandise Exports and Imports
(Billions of 1982 Dollars; Annual Rates)

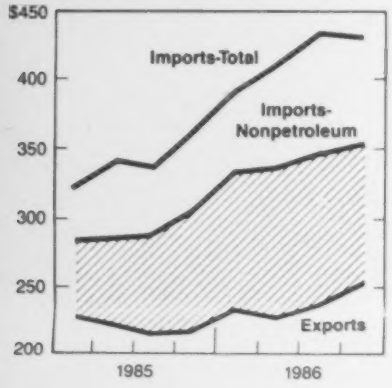
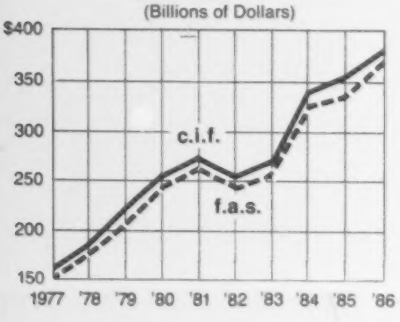


Chart 3
United States Imports
(Billions of Dollars)



The Decline of the Dollar

lished data for what the Commerce Department calls a "statistical month" simply reflect those export and import documents that are *processed* during a period running from the 15th of the preceding to the 15th of the following month. There could be a "month" during which very little merchandise moved because, for example, of a country-wide maritime strike; yet the data (the documents processed) might show a sizable trade deficit. Would the dollar then weaken, on the basis of those statistics?

According to the Commerce Department, a measure "that more closely approximates the actual month of release of imported merchandise by Customs and of the shipment of exports" is published only after a two-month lag. Data reflecting the *actual* months of entry for imports, and of shipment for exports, are compiled only once a year and published during the third quarter of the following year. Thus, what the dollar often reacts to is a set of statistics that bears little semblance to actual trade and even less to the accumulation of additional dollar balances by foreigners (the so-called dollar outflow) occasioned by our trade deficit.

But even if the published data did correspond to actual trade flows, they still would not be an accurate indicator of what foreigners earn from what they sell to us. Since 1980, the Commerce Department has been publishing the monthly trade figures using the "c.i.f" method (cost, including insurance and freight) for valuing imports. Publication of import data under the old f.a.s. (free alongside ship) definition is "withheld" for 48 hours and generally does not make the newspapers. (Between 1973 and 1979 both sets of data were published simultaneously.) With insurance and freight charges added in, imports naturally become larger (Chart 3). In the late 1970s, the annual difference in the import figures ran as high as six percent and in recent years has averaged slightly below five percent. For the trade balance itself, the difference is even more substantial (Table 1).

Congressional proponents of the c.i.f. valuation had long argued for its compilation, claiming as a major advantage that it would provide "more meaningful trade statistics in developing legislation and assessing our trade position." It was also argued that, with most other countries valuing their imports at the port of entry (c.i.f.), the United States was in a sense "undervaluing" its imports. But since the media report only the larger (and hence more unfavorable) set of data, it is easy for an *apparently* weaker trade balance to affect the dollar.

It is in fact misleading to link the monthly data too closely to the dollar. To the extent that freight and insurance on imports are provided by U.S. firms, they do not result in payments to foreigners. Even where shipping and insurance services are provided by foreign countries, in many cases these are not the same countries that are supplying the goods. Thus, only about 95 percent of the value of imports from a given country—recorded c.i.f.—may actually originate in that country.

By how much has the dollar actually fallen since its peak in February 1985 and, more pertinently, what is the most accurate way of measuring that decline? Probably no single measure can be entirely accurate, because of differences in country coverage, in the weights assigned to individual trading partners, and in adjustment for relative inflation rates.

As Morgan Guaranty Trust Company noted last fall, "Disappointment with the limited benefits of dollar depreciation so far has spawned a proliferation of novel exchange rate indices." A major point in the debate is that the dollar actually has fallen very little, and in a number of cases has even appreciated, against the currencies of some of our major trading partners, including Canada and several developing countries, such as Mexico, South Korea and Taiwan.

Table1
U.S. Trade Balance
(Billions of Dollars)

	C.i.f. basis	*F.a.s. basis*
1977	- 39.2	- 29.2
1978	- 42.4	- 31.1
1979	- 40.4	- 27.6
1980	- 36.4	- 24.2
1981	- 39.7	- 27.3
1982	- 42.7	- 31.8
1983	- 69.4	- 57.6
1984	-123.3	-107.9
1985	-148.5	-132.1
1986	-166.3	-152.7

Table 2
Ten Largest U.S. Bilateral Deficits
(Billions of dollars)

	1985	*1986*
Japan	-49.7	-58.6
Canada	-22.2	-23.3
Taiwan	-13.1	-15.8
Germany	-12.2	-15.6
Hong Kong	- 6.2	- 7.1
Mexico	- 5.8	- 5.2
Italy	- 5.8	- 6.5
Brazil	- 5.0	- 3.5
South Korea	- 4.8	- 7.1
United Kingdom	- 4.3	- 4.6

The Dollar and Major Industries

The best-known and most widely-used dollar exchange rate indexes have generally focused on those currencies that are traded most actively in international markets. But those currencies do not necessarily reflect the pattern of U.S. trade today. Some fifteen years ago, U.S. trade with the developing countries accounted for less than 30 percent of all U.S. trade and, on the import side, consisted largely of primary commodities. In 1986, by contrast, the LDCs accounted for about 34 percent of our trade and, more important, provided 26 percent of U.S. imports of manufactures.

Thus, the traditional indexes have excluded East Asian and Latin American countries, which have become important trading partners for the United States. Hong Kong, South Korea and Taiwan, for instance, are among the nine countries with which the United States had the largest bilateral trade deficits in the past two years (Table 2). Any index that did not include these countries might therefore generate overly optimistic expectations concerning improvement in the U.S. trade balance.

A recent effort to remedy this shortfall has been a comprehensive index, computed by the Federal Reserve Bank of Dallas, that encompasses 131 countries (and their currencies) and hence covers virtually all U.S. trade except with the Soviet Union. (It thus includes countries such as Costa Rica and Madagascar, whose total trade with the U.S. amounts to less than $100 million annually). This index registers a decline of less than three percent in the dollar from its peak in early 1985 to the end of last year.

Yet, as Morgan Guaranty has pointed out, it is not necessary to cover every single trading partner of the United States in order to come up with meaningful results. A much shorter list of some forty countries would account for almost 90 percent of total U.S. trade in 1985. A new dollar index, unveiled by Morgan last fall, includes the fifteen major industrial countries covered by the bank's traditional index, plus three additional industrial and 22 developing countries.

One major virtue of this broader index is that it is adjusted for relative inflation rates, which is of major importance once such countries as Brazil and Mexico are included. The index also attempts to measure U.S. international competitiveness—by assigning weights not only on the basis of U.S. bilateral trade in manufactures with a given country, but also in terms of the 38 remaining countries that compete in that country's domestic market. This index shows a drop of some 20 percent for the dollar between February 1985 and the end of 1986. It indicates that by early this year the dollar had fallen back to its average level during 1980-82 (Chart 4).

A somewhat different approach to tracking the impact of the weaker dollar on U.S. trade was taken early this year by Deborah Allen Olivier of the Claremont Economics Institute. Arguing that "how much a particular industry benefits from the dollar's depreciation depends critically upon the pattern of foreign competition for that industry," Olivier computed separate dollar indexes for seven major product categories and 33 subcategories. For each category, movements in the dollar were calculated relative to the currencies of the countries trading with the United States in that particular category. In the one-digit category "food and live animals," for instance, Japan accounts for 11 percent of U.S. trade, Canada for 10, Brazil for 6.8, and so on. Using these shares to weight changes in the dollar against those countries' currencies yielded a "food dollar" index that shows a 35 percent appreciation since early 1985.

On such a basis, none of the seven major product categories emerges more competitive in early 1987 than two years earlier. One might in fact conclude from this exercise that in real life there is no such thing as a

country's foreign trade, but that commercial transactions with other countries take place in numerous markets into which different currencies enter in various combinations and proportions. For instance, in the subcategory "passenger motor vehicles," the bulk of which come from Germany and Japan, the U.S. industry's position appears to have improved by some 23 percent.

However, these industry-specific calculations fail to tell us anything about changes in costs and prices abroad. This is not too serious in the case of the other major industrial countries, where inflation rates have not diverged significantly from the United States. But it creates problems for products traded largely with developing countries. Thus, for trade in coffee the dollar index shows a rise of 127 percent over the two-year period. That reflects, of course, the fact that the dollar has appreciated by some 127 percent on average against the currencies of our major suppliers of coffee, which have suffered astronomical inflation rates. It does not indicate, as a mere reading of the numbers might imply, that the U.S. "coffee industry" has become that much less competitive.

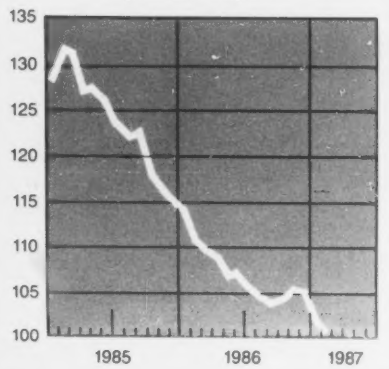
The Dollar Versus U.S. Trade

It is used to be axiomatic that a depreciating currency, after a suitable lag, would benefit a country's trade balance. Given that in two years the U.S. trade deficit appears to have responded little, if at all, to the decline in the dollar, it is perhaps time to revise that notion somewhat.

Chart 4

"Real Effective" Dollar Exchange Rate*

(1980-82 = 100)



*Change in dollar vis-a-vis 18 other industrial-country and 22 developing-country currencies, adjusted for relative inflation rates

First, there are some difficulties with accurately measuring how much the dollar has actually declined since early 1985. While the more comprehensive measures, such as that shown in Chart 4, point to a sizable fall, one can argue that not all of this combined currency effect will necessarily have a bearing on trading patterns. All broader indexes include countries such as Mexico and Venezuela, from which we import mainly oil. Such trade, as well as trade with many smaller countries whose currencies are used chiefly within their domestic economies, is dollar-denominated. The weights assigned to those currencies therefore overstate the importance of their rates vis-a-vis the dollar and distort their contribution to any broader index designed to measure U.S. competitiveness.

A second point that recently has entered the debate is that, to the American consumer at least, price may not be the sole determining factor in making a purchase. While some U.S. imports continue to come in simply because comparable U.S.-made goods are not available, for many others quality, style and status override price considerations. This applies to cars, textiles, a whole range of consumer goods, and various electronic gadgets—even at prices that might appear exaggerated.

Finally, the U.S. trade deficit would benefit vastly more if world economic growth became more robust than by any further dollar depreciation. It is true that the initial effects might be small: It has been estimated that if economic activity outside the U.S. grew by one percent, the U.S. trade balance would improve by some $10 billion per year. But faster growth abroad would also be welcome in the broader global context, expecially if it led to renewed investment and more buoyant economic activity in the developing world.

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World Economic Monitor

Volume 2, Number 3 Summer 1987

AFTER THE VENICE SUMMIT

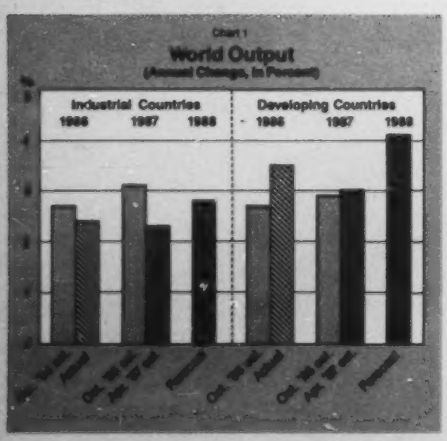
> The crucial decisions are taken domestically. . .To the extent that we can attribute responsibility, the challenges that we are now facing among both industrial and developing countries are the result...of mistakes made at the national level.
>
> John W. Crow, Governor
> of the Bank of Canada,
> April 27, 1987

Beginning with the declaration of the Tokyo economic summit of 1986 right through this year's summit in Venice, all high-level international economic and financial meetings have stressed the importance of international policy coordination in sustaining world economic activity. No one will deny that the benefits of a global economy and of international trade and investment would be lessened, if not lost altogether, if the major countries were to pursue diametrically opposed policies—or, in the words of the International Monetary Fund, policies that are "inadequately harmonized."

This truth has come to be recognized even in the United States. In discussing the adverse effects that a further decline of the dollar might have on the U.S. economy, the Federal Open Market Committee at its March 31 meeting recognized "that the problem was multilateral in nature and that the effectiveness of any policy steps in the United States would be greatly enhanced by complementary actions abroad."

But policy coordination—or at least some form of cooperative effort—will have to differ, depending on the circumstances. At the moment, world economic prospects look none too robust; the scope for policy coordination appears somewhat limited; and the much-touted use of indicators to monitor countries' economic performance is nowhere near implementation.

Only Modest Growth Ahead



As of the spring of 1987, the economic outlook for the industrial countries—and hence for the world economy as a whole—looks somewhat less promising than it did some six months earlier (Chart 1). The International Monetary Fund, for instance, foresees "some moderation in the overall pace of domestic demand expansion." Until quite recently, it had been anticipated that this weaker rate of growth might be counterbalanced to some extent by renewed import growth in the developing countries. However, recent developments in the debt situation—the partial write-off of third-world loans by major banks and hence the prospect for less bank lending—may well put a damper on third-world growth as well.

The downward revision of industrial-country prospects for 1987 reflects a number of factors. Investment spending was hit hard last year in a number of countries and is unlikely to recover in 1987. In the United States, capital expenditures have been adversely affected by the curtailment of tax incentives and, more recently, by rising interest rates. In both the United States and Canada, expenditures were also held down by the sharp decline in oil prices. In other major countries with large export sectors—especially Germany and Japan—investment plans were scaled back promptly in response to the

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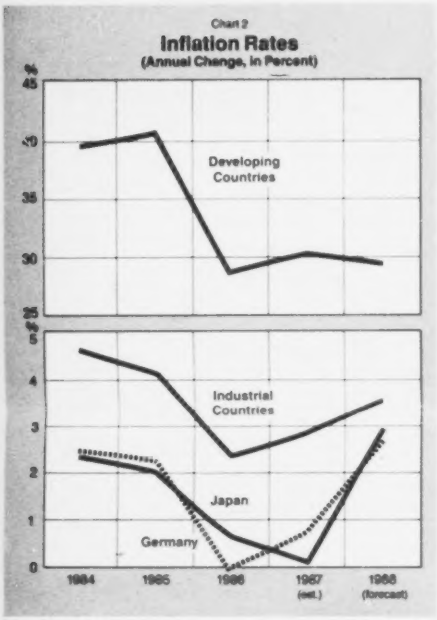


appreciation of their currencies, and growth of demand and output declined fairly rapidly.

On the policy side, financial policies in general are somewhat more restrictive this year than in 1986. In most countries, fiscal policy is less likely to supply a stimulus to business activity, especially at the central government level. And the general easing of monetary conditions that had characterized 1986 is unlikely to recur this year—it may even be reversed, as has already been the case in the United States.

While inflation will largely remain under control in 1987, prices are likely to accelerate somewhat, although inflation rates in general should remain low by historical standards (Chart 2). In the first place, the one-time effect of last year's sharp drop in both oil and commodity prices will not be repeated. Indeed, many observers expect $18 per barrel to be the most likely price for oil this year, although some softening may occur in the second half. Second, it is unlikely that other countries' import prices will benefit to the same extent as in 1986 by further dollar depreciation.

It is interesting to note that when non-U.S. groups discuss the 1987 outlook the performance of the U.S. economy and the effects of the decline of the dollar occupy center stage. Barclays Bank, for instance, notes how "the main cause of the disparity in output growth among the major economies has been the change in competitive positions resulting from the dollar's fall," adding that this year foreign-trade performance will be critical to overall output growth for all major countries outside the United States.

The Commission for the European Communities is even more outspoken. It comments that, in assessing its revised forecast for 1987 (Table 1), the rapidly changing external environment remains "a source of considerable uncertainty." The fact that the dollar depreciated more sharply against the European currencies than had been anticipated in late 1986 further damaged the competitive position of European manufacturers relative to those located in countries with dollar-related currencies. In addition, total world trade is likely to expand somewhat less in 1987 than had been hoped for earlier.

Table 1
1987 Economic Indicators for the European Community

	*Real GNP**		*Consumer Prices**		*Unemployment #*	
	Forecast of		*Forecast of*		*Forecast of*	
	10/86	*1/87*	*10/86*	*1/87*	*10/86*	*1/87*
France	2.5%	1.8%	2.3%	2.8%	10.7%	11.1%
Germany	3.2	2.0	1.1	0.8	7.7	7.9
Italy	3.6	3.2	4.0	4.0	12.8	13.7
Netherlands	1.8	1.6	-1.0	-0.8	11.1	11.2
United Kingdom	2.7	2.9	3.9	4.3	12.0	11.3
European Community (12 countries)	2.8	2.3	3.0	3.2	11.7	11.8

* annual change
\# as percent of labor force

Thus, the expected contraction in exports—which in Western European countries make up between 25 and 60 percent of GNP—and the uncertainly "surrounding future developments in the external environment" are the main reasons why economic growth in the Community will be lagging behind North America and Japan for the fifth consecutive year. This downward revision in growth prospects will, in turn, affect the unemployment rate which, for the twelve member countries as a group, is projected to remain largely unchanged from 1985 and 1986.

Limited Scope for Policy Coordination

The debate over policy coordination among the major industrial countries has never made it quite clear whether such action was intended to benefit the world economy as a whole, help reduce the sizable external imbalances of the three major economies, or help stabilize the dollar. The Venice declaration stressed all three goals.

Granted, there now is a firmer commitment by all major industrial countries at least to cooperate on certain aspects of their national policymaking. The clearest instances of such a cooperative effort have been in the exchange-rate area, such as the September 1985 Plaza Accord, which set the stage for a "further orderly appreciation of the main nondollar currencies." In early 1986, there also were two "coordinated" discount rate reductions, the first involving the United States, Germany and Japan, and the second this country and Japan only. Both moves were widely seen as attempts to promote greater dollar stability.

But beyond such specifically targeted actions, commitments by the seven summit countries—as, for instance, in the Louvre agreement of this past February—have simply promised to: (1) reduce government deficits in North America; (2) apply fiscal stimulus in countries that have the leeway to do so; and (3) reduce interest rates wherever this would not risk rekindling inflation.

Such general and largely self-evident actions alone are not sufficient to deal with the major disequilibrium overhanging the world economy—the large U.S. payments deficit and its counterpart, the country's increasing international indebtedness. In the past, a relatively stable dollar *and* a satisfactory trade performance were achieved only when growth in other major industrial countries exceeded that in the United States, as was the case in the 1960s. In the 1970s, both growth rates were fairly similar, but dollar depreciation benefited the trade balance. Between 1982 and 1985, by contrast, U.S. domestic growth exceeded that of the other industrial countries by a cumulative 9.5 percent.

At this particular time, a combination of faster growth abroad and further dollar depreciation would therefore be the most favorable solution to the U.S. payments imbalance. Table 2, prepared by Morgan Guaranty Trust Company, indicates the various estimated combinations that would be required to reduce both the U.S. trade and current-account deficits to below $100 billion by 1989. These estimates suggest that only a further decline of the dollar would achieve that target without, at the same time, requiring unrealistically low growth in the United States or an unrealistically rapid acceleration of foreign growth.

What scope is there for Germany and Japan to boost their growth rates, if only to those projected in the third scenario of the table? Both countries would appear to have some elbow room for fiscal stimulus, since their public-sector deficits have fallen to around only 1 percent of GNP (Chart 3).

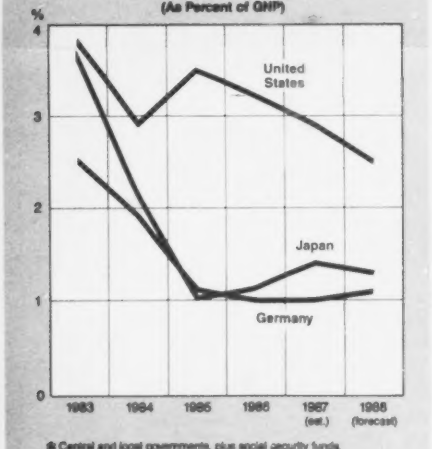
At the beginning of June, the Japanese government announced a $42 spending package—comprising $35 billion in public-sector outlays and a $7 billion tax cut—that eventually would add an estimated 1.6-2.0 percent to GNP growth. But the program's impact on imports, and hence on the country's trade surplus, is expected to be minor. Germany in early May announced a token reduction in the central bank's rate for open-market operations—hardly an economic stimulus—and at the same time made it quite clear that there was "no maneuvering room" for bringing forward or enlarging the tax cuts slated for 1988. Moreover, the drop in both countries' exports will lower their GNP growth by an estimated 1 percent this year.

But while Germany's overall external surplus is projected to decline by some 20 percent between 1986 and 1988, Japan's is expected to fall by no

Table 2
Growth and Exchange-Rate Combinations to Reduce U.S. Trade Deficit to Below $100 Billion by 1989

	End of 1988 Exchange Rates		*Annual GNP Growth, 1987-89*		
	Yen/$	DM/$	Japan	Germany	U.S.
1)	154	1.85	5.4	5.4	1.0
2)	154	1.85	6.3	5.7	2.0
3)	125	1.60	4.3	3.4	2.0
4)	125	1.60	5.5	5.0	3.0

Chart 3
General Government Deficits*
(As Percent of GNP)



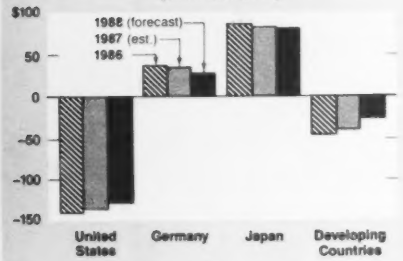
* Central and local governments, plus social security funds.

more than 5 percent (Chart 4). For one thing, Japan's exports are some 80 percent larger than its imports, so that the latter would have to rise sharply to make a major dent in the surplus. Second, by having become the world's largest creditor nation—with net external assets of $180 billion an the end of 1986—increasing investment income from abroad will tend to offset whatever reductions in the trade balance may be achieved.

Guiding Policy by Economic Indicators?

The debate on policy coordination has continued to stress the use of economic indicators—including growth and inflation rates, money supply, fiscal deficit, the external balance, and exchange rates—as guides to "multilateral surveillance" of each country's policies. Use of these tools, the IMF has noted, could "strengthen the basis for assessing the international repercussions" of policies and policy objectives. In case of "significant deviations" from projected targets, the 1986 Tokyo communique declared, the seven countries' finance ministers and central bank heads would "make their best efforts to reach an understanding on appropriate remedial measures." The Venice declaration basically reaffirms that commitment.

Chart 4
Current Account Balances
(Billions of Dollars)



In a February, 1987, study *(Strengthening the International Monetary System,* Occasional Paper No. 50), the IMF sorted out the various available indicators and their potential scope. The study distinguished between three types of indicators: (1) those of economic performance, covering "the more fundamental objectives of economic policy," such as growth, unemployment, and balance-of-payments and price stability; (2) those of economic policy, namely "variables over which the authorities have fairly close control," such as monetary growth, exchange market intervention, and the fiscal deficit; and (3) intermediate variables, such as savings and investment, and interest and exchange rates—that is, variables that respond to policy and thereby can influence performance. With the emphasis currently placed on the international interactions and repercussions of national economic policies, any analysis would necessarily have to focus on policy indicators.

But we probably are quite a ways from fashioning sets of indicators for the major countries that would ensure implementation of mutually consistent policies. There are a number of points that have to be cleared up first. These include development of a mechanism for collecting and analyzing national forecasts on a strictly comparable basis; establishment of criteria for judging the consistency or "harmony" of individual national policies and objectives; and agreement on negotiating procedures when actual developments diverge from targets. Thus, progress toward a systematic use of indicators can only be very gradual.

In fact, one basic obstacle to achieving policy coordination is disagreement over the way the economic system and individual economies function and especially over the mechanism by which economic policies are transmitted. As Robert Solomon of the Brookings Institution has pointed out, countries need to agree not merely on policy goals, but also on a common view "of how the world works—that is, what happens when you push a given lever."

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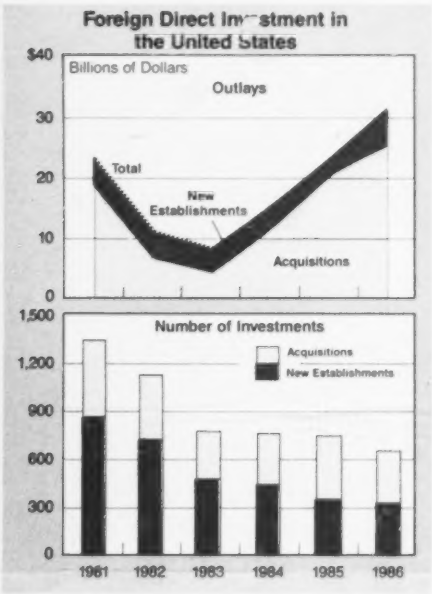
The Conference Board's **Economic Analysis Program**

World Economic Monitor

Volume 2, Number 4 Autumn 1987

FOREIGN DIRECT INVESTMENT IN THE UNITED STATES

Chart 1



Foreign direct investment in the United States, lately much in the news, is not a new phenomenon. In the early days of the nation, British, Dutch, French and German investments were largely responsible for financing the infrastructure that stimulated the country's economic development.

But then, as now, such investment met with some concern that the United States might be "selling out" to foreigners. This situation prompted Alexander Hamilton, the first Secretary of the U.S. Treasury, to remark in 1791, "Instead of being viewed as a rival, [foreign investment] ought to be considered as a most valuable auxiliary, conducing to put in motion a greater quantity of productive labor, and a greater portion of useful enterprise, than could exist without it."

The task of assessing to what degree foreign investors "own" and influence the U.S. economy is complicated by the broad definition of a foreign affiliate. Generally, direct investment is a smaller share of total foreign investment here than perceived by the public. Financial investments actually are a greater burden on the U.S. balance of payments.

Between 1981 and 1986, annual outlays by foreign firms for acquisitions and construction of new facilities in this country rose by one-third; compared to 1982, a year characterized by recession, high borrowing costs, and a strong dollar, 1986 outlays had nearly tripled (Chart 1). At the same time, however, the *number* of new foreign investments has shrunk by about 50 percent. But this simply means that, just like in the domestic economy, individual deals have become very much larger.

The two biggest foreign acquisitions last year amounted to $3.6 billion and $2.0 billion, respectively; the ten largest had a combined value of $10.2 billion. (Several British acquisitions in 1987 also have been in the $1 billion-plus range.) Nevertheless, foreign acquisition activity in 1986 continued to be dwarfed by mergers and acquisitions among U.S. firms that were over seven times as large in value and ten times as many in number. In contrast to these fairly straightforward numbers, the role or share of foreign-owned enterprises in total U.S. business activity or in individual sectors is somewhat more difficult to pinpoint.

How Large A Presence?

What is often overlooked in the heat of discussing foreign "buying sprees" is that foreign direct investment constitutes only a small part of the recent wave of incoming foreign capital. Estimates of the book value of foreign direct investment in the United States are published regularly by the Department of Commerce. Thus, we find that between 1981 and 1986 the value of foreign-owned enterprises and other holdings (including real estate) almost doubled. But it is more complicated to relate those totals (or their annual increments) to the U.S. economy as a whole. One could say, for instance, that in 1986 the increase in foreign direct investment amounted to about 5.5 percent of U.S. expenditures on plant and equipment.

However, since foreign direct investment has occurred in virtually every

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major sector of the U.S. economy, across a broad range of products and services, such a statement tells us very little about the impact on individual sectors or industries. To gauge the relative importance of the foreign presence at the sector or industry level, it would be more meaningful to use the most significant measure, such as sales or assets in most manufacturing, capacity in forest products and the iron and steel industry, construction engineering fees, and circulation in newspaper and magazine publishing. Obviously, those measures cannot be averaged or "summed across" to yield a grand total for all foreign operations in the United States.

But even at the individual industry levels there are hurdles to overcome. Since a U.S. affiliate is defined as any U.S. enterprise "in which a single foreign person owns or controls. . .10 percent or more of the voting securities. . .or an equivalent interest," ownership patterns differ widely. It is possible to examine U.S. operations that are 100 percent foreign owned and then to calculate them as a share of a particular industry. But virtually every industry also contains numerous firms with foreign ownership of less than 100 percent. How could these be combined with wholly owned firms and included in a "measure" of foreign presence? In all such cases, the percentage of a U.S. industry's sales (or assets or capacity) accounted for by foreign affiliates would tend to overstate the participation of foreign investors in that

TABLE 1

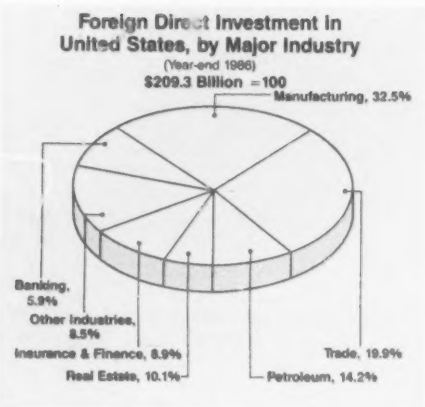
TEN LARGEST FOREIGN INVESTMENTS
By Affiliate Sales
(End of 1986)

Foreign Investor	*Country*	*U.S. Investment*	*Percent Owned*
Seagram Co.	Canada	E.I. du Pont	23
		Joseph E. Seagram	100
Royal Dutch Shell	Netherlands/ United Kingdom	Shell Oil	100
British Petroleum	United Kingdom	Standard Oil Ohio	95
		BP North America	100
B.A.T. Industries	United Kingdom	BATUS	100
		Peoples Drug Stores	100
		Imasco USA	100
Tengelman Group	Germany	Great A&P	52
Unilever NV	Netherlands	Chesebrough-Pond's	100
		Lever Brothers	10[illegible]
		Thomas J. Lipton	100
		National Starch and Chemicals	100
Nestle	Switzerland	Nestle Enterprises	100
		Carnation	100
		Alcon Laboratories	100
Mitsui & Co.	Japan	Mitsui & Co. USA	100
Petroleos de Venezuela	Venezuela	Citgo Petroleum	50
		Champlin Refining	50
Usines Renault	France	American Motors	43
		Mack Trucks	42

Source: *Forbes*

sector. Table 1, therefore, has to be interpreted with care, since the ranking is based on the 1986 sales of the U.S. affiliates, one-third of which were not wholly owned.

Chart 2



Perhaps the least controversial measure of the foreign presence is employment by U.S. affiliates—although even here the broad interpretation of foreign ownership tends to overstate the true shares. Overall, foreign-owned firms (excluding banks) accounted for about 2.9 percent of total U.S. nonagricultural employment in 1985 (latest year available). On the other hand, the employment share in manufacturing and in trade—which account for over half of foreign direct investment (Chart 2)—were considerably higher, at 7.5 and 3.3 percent, respectively.

There also was considerable variation within manufacturing itself. Foreign-owned affiliates accounted for 41 percent of employment in the chemical industry, for 8.7 percent in electric/electronic equipment and for 5.3 percent in nonelectrical machinery. The foreign share in the service industries, excluding wholesale trade, generally was around 3 percent or less.

In most states, foreign-owned firms likewise accounted for around 3 percent of nonagricultural employment (Table 2). In Delaware, however, "foreign" employers provided work for as much as 12 percent of the state's labor force—simply because the state's single largest employer is 23 percent foreign owned!

TABLE 2

Share of Employment of Nonbank Affiliates, 1985, By State

	Employees (in thousands)	*Percent of state nonagricultural employment*
California	299.3	2.7
New York	239.3	3.1
Texas	212.2	3.2
New Jersey	153.4	4.5
Pennsylvania	150.2	3.2
Illinois	144.3	3.0
Ohio	137.9	3.1
North Carolina	116.2	4.4
Georgia	107.0	4.2
Florida	95.2	2.1

Direct Investment Versus Other Capital Flows

By a different measure, however, the U.S. affiliates of foreign companies are considerably more prominent—they are major exporters and importers. In 1985, affiliates provided 26.5 percent of total U.S. exports and took in 32.3 percent of all U.S. imports. The U.S. affiliates of Japanese companies accounted for more of U.S. trade than affiliates from any other country. In fact, the value of exports by Japanese-owned enterprises here was roughly equal to total U.S. exports to Japan in 1985; much of this trade is of course generated by the U.S. operations of the large Japanese trading houses.

Foreign-owned affiliates in the United States have consistently shown a fairly large trade deficit, and in 1985 contributed more than 40 percent of the overall U.S. deficit. This reflects the general trading pattern of foreign affiliates everywhere: They rely on their home countries, and particularly on their parent companies, for shipments of parts and components for further processing. (By contrast, U.S. trade with U.S. affiliates abroad was virtually in balance in 1985 and had shown consistent surpluses in previous years.)

To put foreign direct investment in the United States into proper perspective, it is worth noting that it has constituted only a relatively small share of the massive capital flows to this country in recent years. Although the building of new plants and the acquisition of U.S. enterprises by foreign multinationals have made headlines, foreign investors have increasingly selected from the broad range of U.S. financial instruments—from bank deposits and CDs to corporate and Treasury securities—that have long been their favorites.

Thus, while foreign direct investment accounted for 25 percent of the increase in privately owned dollar assets in 1984, it was responsible for only 14 percent of the nearly $180 billion increase in such assets last year. Similarly, the bulk of foreigners' earnings on their dollar holdings, which will continue to be a drain on this country's external accounts for years to come, consists of interest on financial instruments. Thus, in 1986 some $60 billion was earned by foreigners from all types of financial instruments, as against only $5.8 billion from their direct investments in the United States.

The U.S. Direct Investment Position

Chart 3

There has been much discussion lately of the United States' having become an international debtor—according to some versions, larger than either Brazil or Mexico. Whether one subscribes to that notion or not—it would be more accurate to say that the U.S. international investment position has turned negative—the U.S. position on direct investment has remained positive (Chart 3).

True, the U.S. creditor position on that account has been shrinking. At the end of 1981, foreign direct investment in the United States totaled less than half of U.S. direct investment abroad; by end 1986, that portion had risen to close to 80 percent. It is possible, however, that the official figures tend to overstate the size of foreign direct investment in the U.S. relative to outgoing investment. This is simply because the bulk of incoming investment has taken place in recent years and thus is recorded at current prices.

U.S. direct investment abroad is of course much older—it began around the turn of the century when the United States, like today, was a net borrower from abroad. But such investment likewise is carried at book, rather than market value—much of it at prices of the 1960s and early 1970's, when the bulk of U.S. outward investment (the "American challenge") took place. Its true value, and hence the U.S. creditor position on direct investment, probably is considerably larger than the official figures show.

Investing in the United States: A Recent European View

Why are European businessmen interested in entering, operating, and investing in the U.S. market? For a European company, a presence in the United States is an important step toward competing successfully with American firms in the world market.

The American market is strategic because it offers a series of unique resources. A powerful lure is the scientific and technological environment, the existence of a "system effect" that increases the efficiency with which each company, large or small, American or not, participates in the innovation process...

A second reason for European interest in the United States is financial. The great magnitude of U.S. capital markets yield stability; large transactions do not upset the market. The U.S. market is endowed with a diversified system of financial intermediation. The presence of institutional investors, such as pension funds, gives the American market great stability and offers business a large source of risk capital to finance its investments.

A third attraction of the U.S. market is its dimension and homogeneity. The European market is large but segmented.

—Mario Schimberni, Chairman and CEO, Montedison S.p.A., at a March 1987 conference sponsored by National Bureau of Economic Research

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The Conference Board

Economic and Business Environment Program

World Economic Monitor

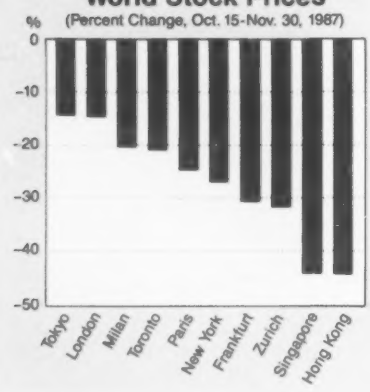
Volume 3, Number 1 Winter 1988

BACK TO THE DRAWING BOARD

The world that needs to be forecast has deteriorated. You used to be able to be pretty sure of getting things quantitatively right even if the magnitudes were wrong, but even that has disappeared.

Paul A. Samuelson in *The New York Times*, December 20, 1987.

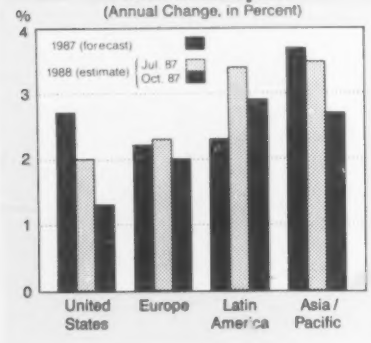
Chart 1
World Stock Prices
(Percent Change, Oct. 15-Nov. 30, 1987)



Members of The Conference Board's Economic Forum, meeting in mid-November, agreed that the October stock market collapse certainly spelled trouble for economic forecasting. Every component of the Forum's forecast for 1988 was colored by the drop in equity prices and thus had to be analyzed in terms of "before" and "after" the crash. Of course, the same holds true for the other major industrial countries.

Since sharply falling stock prices were not confined to the United States (Chart 1), the repercussions for the world economy are even more severe. For 1988, forecasters must not only estimate the crash's impact on consumption, investment, government spending and trade, but must also factor in such illusive variables as consumer confidence and investor psychology. Although these challenges make it more hazardous than usual to forecast worldwide economic activity—projections made early last fall are now of no value—it is possible to agree on some of the broader implications of last October's events. It is also worthwhile to frame some pertinent questions concerning the features of the economic landscape in the year ahead.

Chart 2
World Output
(Annual Change, in Percent)



The crash's implications for 1988:

- Slower economic growth in the major industrial countries will largely reflect the ripple effect of slower growth in the United States, rather than the "wealth effect" of the world financial market decline itself. This is in part because outside the United States equity holdings account for a far smaller share of private-sector financial assets.
- The worldwide inflationary threat has receded dramatically. Even before October 19, many observers felt that sharply rising commodity prices would soon moderate. The events of October, plus the outcome of OPEC's December meeting (pointing to lower oil prices), appear to support this view. For the industrial countries in particular, inflationary pressures will be related to the level of capacity utilization. On that basis, the risk of rising prices would seem greatest in the United States and least in Japan, with Europe somewhere in between.
- Although the major countries' monetary authorities have once more agreed to support the dollar, downward pressures on that currency may well persist until the United States convincingly addresses two fundamental economic imbalances—the trade and budget deficits. On that score, encouraging developments are likely to be seen sooner on the budget than on the trade front.

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The events of last October also raise some major questions:

- If the United States—which still accounts for almost one quarter of world output—grows even more slowly in 1988 than in 1987, who will take up the slack? Toward year-end, most of the major world players adopted economic measures that have been characterized as "therapeutic."

  The central banks of Germany, the United Kingdom, France, the Netherlands, Switzerland and Austria all lowered their discount or other key lending rates by 25 to 60 basis points, but these actions proved insufficient to support the dollar. In addition, Germany announced some modest fiscal measures, including interest subsidies on $13 billion worth of loans to small- and medium-sized businesses by an official lending agency, to be spread over the next three years. The German authorities took no action, however, to either reduce taxes or to boost government spending at this point.

  Japan did not join in the (obviously coordinated) European moves toward lower interest rates, presumably because of extraordinarily strong domestic growth. (The Japanese economy grew at an annual rate of over 8 percent in the third quarter.) Given a rise in business activity in Japan and postwar lows in German interest rates, these two countries may be able to take up some of the slack created by a slow-moving U.S. economy. However, they are not likely to concede any further expansionary measures.

- What is in store for privatization? Not only investors racked up losses as a result of October's crash. Given the uncertain investment climate, many governments also have had to reassess or postpone their plans for privatization—the selling off of publicly owned companies to the private sector. This has forced them to reduce their spending plans or to incur larger-than-planned budget deficits. The setback has affected most of Europe, from the major industrial countries to Spain and Turkey. For instance, Air France has delayed the planned sale of a 15 percent stake to the public, and the German government has postponed the long-awaited sale of its remaining 16 percent holding in Volkswagen until some time in 1988. In other words, the trend of recent years toward broadened stock ownership—what *The Economist* has called "the greatest exchange of money and property between private citizens and their governments"—has lost momentum.

- What is the outlook for further financial deregulation? It was widely assumed that the events of October would slow the pace of financial deregulation that had been under way in many countries. Many observers assumed that stricter supervision and controls would ensue. So far, even though there have been casualties among financial firms, there has been no major tightening in the regulatory environment. Progress on deregulation may be somewhat slower, however. The Swiss, for instance, are likely to tread carefully when they introduce a market in futures and options early in 1988.

- Has the much-touted coordination of international economic policy fallen victim to the market collapse? One might easily have thought so when efforts by U.S. officials to "talk the dollar down" were interpreted as a way of "punishing" the Germans for a rise in interest rates. (The temporary rise resulted from a proposed 10 percent withholding tax on interest payments that would take effect in 1989.) At the same time, the continued downward drift of the dollar between mid-October and Christmas raised doubts as to whether last February's Louvre Accord was still in force. The accord was designed to maintain some (unpublicized) target zones for the dollar. Although the seven major industrial countries announced on December 22 that they would continue to cooperate to keep the dollar from declining further, the statement did not hint at further policy changes on the part of any of the seven.

  Moreover, voices have been raised, notably that of former Council of Economic Advisers Chairman Martin Feldstein, to the effect that each government should learn to deal with its own problems and politicians should not attempt to escape their responsibilities by blaming poor domestic ecnomic performance on faulty policies abroad. According to Feldstein, writing in *The Wall Street Journal,* the United States should "end the international coordination of macroeconomic policy." While the United States might continue to exchange information about policy decisions with other major countries, "we should recognize explicitly that Japan and Germany have the right to pursue the . . . policies that they believe are in their own best interests." As Goethe once observed, if everyone swept in front of his own door, the whole world would be clean.

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The Conference Board

Economic and Business Environment Program

World Economic Monitor

Volume 3, Number 2 Spring 1988

U.S. FOREIGN TRADE
At A Turning Point?

Financial markets in general view the [trade] deficit as a monthly measure of U.S. economic health.
The Wall Street Journal

Source: Department of Commerce

One need not agree with the above to conclude that the January-February 1988 trade data look slightly encouraging and seem to confirm the improvement in the U.S. trade position that became apparent toward the end of 1987. True, even at the January-February rate, the United States would chalk up close to a $160 billion deficit in 1988. True, the January 1987 results looked similarly favorable and were reversed in the ensuing months. True, the U.S. bilateral deficits with Western Europe and Japan still loom exceedingly large. But despite these provisos and what Deutsche Bank has called "the notorious fragility" of the monthly data, one can discern a turning point in the U.S. trade accounts:

- In volume terms—that is, in constant dollars—the deficit has been declining since the fourth quarter of 1986 (Chart 1).
- There has been a marked expansion in exports from such major categories as machinery and equipment and consumer goods (Chart 2).
- The deficits on the U.S. trade accounts with its largest trading partners—Japan, Western Europe and Canada—are now a smaller share of the total U.S. trade deficit than in 1986 (Chart 3).

As a result of the improved trade picture, 1 to 1.5 percentage points may be added to the U.S. growth rate in 1988.

What the "Current" Numbers Show

The year 1987 saw the largest trade deficit in U.S. history—$171.2 billion. This widening, from $156.2 billion in 1986, can be attributed to the fact that the value of both exports and imports rose at approximately the same rates (11.5 and 10.7 percent, respectively). Given the large discrepancy between the two categories—with imports almost 70 percent higher than exports—exports would have to grow almost twice as fast as imports just to stop the trade balance from deteriorating further in 1988.

It is unfortunate that so much importance is given to the month-by-month changes in the trade data in current dollars, i.e., in value terms. There is, of course, plenty of validity to current-dollar figures: For one thing, the U.S. current account, which measures the change in the total U.S. international position, is reported in current dollars only; for another, interest and dividend payments to foreign owners of dollar assets have to be made (and hence earned) in current dollars; and third, companies' international operations and earnings are all recorded in current dollars.

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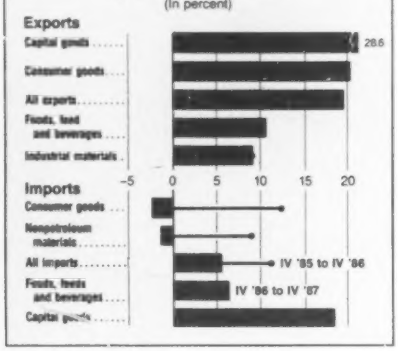
However, in using the monthly figures—which both the media and the financial markets dote on—one must bear in mind several caveats. First, the data are not seasonally adjusted—and seasonal factors tend to make reported deficits smaller during the first half of the year and larger during the second half. (The Commerce Department is planning to publish seasonally adjusted figures beginning with the April data, to be released in mid-June). Second, there is what has been called "the potentially erratic pattern of crude oil imports." These exhibit often wide fluctuations in both volume and price. Thus, the *nonpetroleum* deficit last year was only some $6 billion above that of 1986.

Third, with imports valued at spot exchange rates on the day import entry forms are filed with Customs, a sharp drop in the dollar from one month to the next can easily cause a jump in import values. Finally, aircraft shipments—for years the leading U.S. export item—can vary by as much as $1 billion from one month to the next.

The "Real" Story

The more important clues are to be found in the "real" trade balance, which affects the national accounts and hence the performance of the U.S. economy as a whole. Thus, between 1980 and 1986, the trade balance (on goods and services combined) swung from a $57 billion surplus, in constant dollars, to a $146 billion deficit. This deterioration of over $200 billion in the country's net exports resulted in a loss of nearly 1 percentage point in U.S. economic growth—to a 2.6 percent annual average. In contrast, in 1988 the turnaround in the U.S. trade position will have a positive effect on the economy.

Chart 2
Change in Trade Volume, by Major Categories
(In percent)



Source: Department of Commerce

The improvement in the U.S. trade account will have negative implications for other countries' growth prospects in 1988, however. The OECD has calculated that if the dollar were to stay at its November 1987 level (DM 1.66 and Yen 133), then Europe's growth would be reduced by 0.75 percent this year (Table 1). According to OECD calculations, if the dollar were to depreciate by another 15 percent from last November's level—that is, to DM 1.41 and Yen 114—domestic demand in both Europe and Japan would have to increase by almost 1 full percentage point this year in order to offset the slowdown of foreign demand. While such a depreciation is by no means assured, this scenario calls for Europe and Japanese policymakers to do more to stimulate demand in their countries.

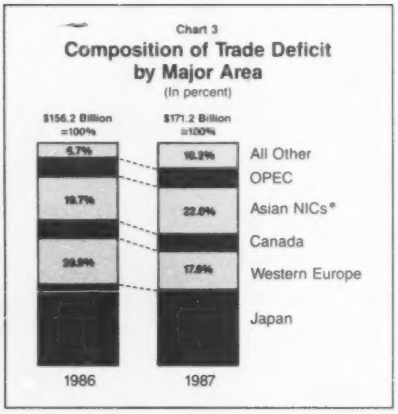
This argument has now permeated economic journalism and is even influencing high-level policy thinking. For example, the British Chancellor of the Exchequer, Nigel Lawson, recently suggested that growth in demand in surplus countries coupled with a decline in demand in deficit countries would be sufficient to solve global trade imbalances, without further depreciation of the dollar.

However, the real world does not work quite that way, since the residents of different countries spend their incomes differently and, in fact, spend the largest proportion on goods and services produced at home. As Professor Paul Krugman of MIT wrote recently, "Even in import-hungry America, well over 90 cents of each dollar of spending goes to goods and services produced here. . . [while] no more than 2 or 3 percent of Japan's spending is on goods made in the U.S. If the U.S. cuts its expenditures without doing something else at the same time, there will be a fall in the demand for U.S. goods; even if other countries simultaneously increase their spending by the same amount, their increased demand for U.S. exports will compensate for only a small fraction of the reduction in domestic demand."

Table 1
Sources of Growth, 1987 and 1988
(annual change, in percent)

	*1987**	*1988***
United States		
Domestic demand	2.0	1.0
Foreign demand	0.75	1.5
Total demand	2.75	2.5
Western Europe		
Domestic demand	3.25	2.5
Foreign demand	-1.0	-0.75
Total demand	2.25	1.75
Japan		
Domestic demand	4.25	4.0
Foreign demand	-0.75	-0.5
Total demand	3.5	3.5

Source: OECD
*estimate
**forecast



* Hong Kong, Singapore, South Korea and Taiwan
Source: Department of Commerce

This line of reasoning leads, of course, to calls for a further fall in the dollar—since to make things work out, the rest of the world obviously has to shift a larger part of its (increased) spending from domestic to U.S. goods. Advocates of such a course argue that the only way to achieve this is to make U.S. goods and services still cheaper.

However, one side effect of a still lower dollar would be a further rise in import prices and, with it, a further fall in the terms of trade (Chart 4)—the ratio of the prices of exports to the prices of imports. Such a fall means that the same quantity of exports no longer buys as large a physical quantity of imports as before. Thus, while higher exports will help boost the output of goods and services, the country's so-called "command" over goods and services from domestic production will have declined—and we will truly have tightened our belts.

The Deficit and the Trade Bill

The sharp rise in the 1988 trade deficit has of course had some effect on the fate of the trade bill currently before the Congress. This is especially true for various amendments that would have restricted trade with those foreign countries that have fairly large trade surpluses with the United States: Japan, Taiwan, West Germany, Canada, and so on.

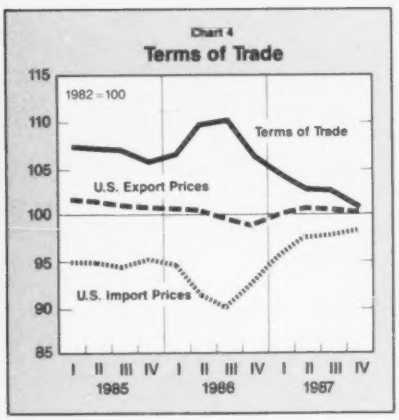
Such measures always run the risk of retaliatory action by the countries affected. But in the case of the United States, there is an added irony. A recent National Foreign Trade Council compilation has shown that the countries where the United States enjoys the largest markets for its exports also tend to be countries with which the U.S. has the largest trade deficits (Table 2).

Table 2
Top 10 U.S. Trading Partners Ranked According to Three Criteria

Ranked by total trade (exports plus imports)	*Ranked by size of trade imbalance*	*Ranked by size of U.S. export market*
1. Canada	1. Japan	1. Canada
2. Japan	2. Taiwan	2. Japan
3. West Germany	3. West Germany	3. United Kingdom
4. Mexico	4. Canada	4. Mexico
5. Taiwan	5. South Korea	5. West Germany
6. United Kingdom	6. Mexico	6. Netherlands
7. South Korea	7. Hong Kong	7. South Korea
8. France	8. Italy	8. France
9. Italy	9. Brazil	9. Taiwan
10. Hong Kong	10. China	10. Belgium

Source: National Foreign Trade Council.

Trade and the Global Factory



Source: Department of Commerce

Finally, there is an issue that has been raised repeatedly in this publication—that of the globalization of manufacturing, including sourcing from a number of different countries and increased in-house or intracompany trade. This development has dulled the responsiveness of our trade accounts in general to exchange-rate shifts. Firms that rely on a global network of facilities to support their U.S. operations can react differently to exchange-rate shifts than firms that are supplied by a company that is foreign. Thus, as this phenomenon increases and as a greater share of U.S. trade comes to involve transactions between affiliated parties, less and less of U.S. trade will become sensitive to exchange-rate swings.

This phenomenon is of course not limited to U.S. multinationals. For instance, as Japanese firms increase their investment in this country, and move facilities into Southeast Asia to escape the effects of the appreciated yen, the proportion of total world trade subject to "globalization" will rise further. In the case of the Japanese automakers investing in the United States, a large amount of "tied trade" in imported subassemblies and parts likewise will be less influenced by the exchange rate than fully assembled imports would be. Still, the U.S. is certainly far from the point, recently postulated by a Washington consultant, where the Japanese will produce so much here that within a few years "hardly any" goods would be imported from Japan.

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The Conference Board

Economic and Business Environment Program

World Economic Monitor

Volume 3, Number 3 Summer 1988

U.S. SERVICES IN INTERNATIONAL TRADE

Services have come to dominate production in most industrial countries, accounting for at least half of total output in OECD member states. In 1987, nongovernment services accounted for almost 60 percent of U.S. gross national product and 57 percent of civilian employment. At the same time, both the types and value of services traded internationally have risen markedly, with total world services exports estimated at $400 billion annually.

Yet, despite the predominance of services in the U.S. economy, the contribution of trade in services to the U.S. international accounts is modest and likely to remain so:

- While U.S. exports of services have roughly doubled over the past ten years, they still amount to less than one quarter of merchandise exports.
- The *balance* on services trade is relatively small and hence does little to help offset the continuing large deficits on merchandise trade.
- Most international activity in services is linked closely to trade (shipping) and intellectual property (fees and royalties). In 1987, the "newer" kinds of internationally traded services, such as construction and consulting, accounted for less than one quarter of U.S. services exports.
- As in the case of goods, U.S. multinationals sell a considerably larger share of services through their foreign affiliates than through direct sales from the United States.

The Role of Services

The amounts generated by U.S. international trade in private business services (see box) are relatively small. Even though over the past ten years both exports and imports of services have more than doubled (Chart 1), in 1987 services exports and imports equaled only 23 percent and 14 percent of merchandise exports and imports, respectively. As a result, the surplus on services trade has also remained small, affording only a minute offset to continuing large deficits on merchandise trade (Chart 2).

Chart 1

Source: Department of Commerce

Despite the high portion of U.S. output represented by services, it is highly unlikely that trade in services will ever replace trade in goods as a major factor in U.S. international transactions. For one thing, the bulk of activity in business services is closely linked to trade and investment in general. Traditionally, within the business services category shipping and fees and royalties related to proprietary rights have, together with tourism, accounted for the bulk of transactions. Trade in such services must therefore be seen as complementary to merchandise trade and investment activity—and will likely move in the same direction and at the same pace.

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The "newer" or "emerging" services, such as construction, consulting, and communications, on which hopes for offsets to the trade deficit are generally pinned, account for only a small part of the total—about 22 percent of services exports in 1987 (Chart 3).

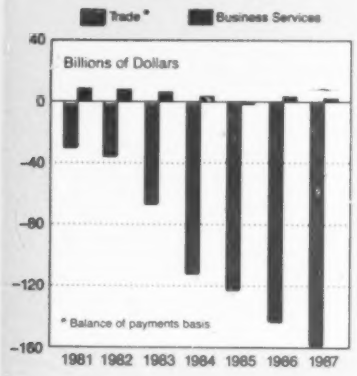
Measuring Services

There are several reasons why the statistics on trade in services are relatively low. Perhaps most important, international barriers to the transfer of the newer and less traditional business services remain formidable. There are also considerable problems in gathering the data.

A 1986 report by the Office of Technology Assessment (OTA) of the U.S. Congress found that the current system of reporting U.S. trade in services results in major errors that "arise in part from difficulties inherent in measuring production and trade in the services. Most services, as intangibles, cannot be stored, transported, or counted as they cross national borders." Moreover, "procedures for data collection and estimation have not kept pace with the growth in volume and diversity of international service activity."

Chart 2

Balances on Trade and Business Services



Source: Department of Commerce

Services: Some Definitions

The service account in the balance of payments has been described as "a composite of many dissimilar types of transactions." Yet, these have a common denominator since they involve selling part of the output of the United States or providing a return on U.S. capital invested abroad and foreign capital invested in this country.

The present discussion focuses exclusively on "private business services," that is, international transactions between private parties that are of a strictly business nature or incidental to other business transactions. Interest and dividend payments fall into another category. In detail, private business services include:

- Travel: Services provided to U.S. citizens traveling abroad and to foreigners traveling in the United States.
- Passenger transportation: Transportation provided to U.S. residents by foreign carriers and to foreign residents by U.S. carriers.
- Shipping: Services involving freight movements and use of port facilities.
- Proprietary rights (included in the balance of payments as "fees and royalties"): Payments for the use or sale of intellectual property rights, such as patents, processes, copyrights, trademarks, and franchises.
- Other business services: Construction, engineering, architecture, consulting, banking, brokerage, communications, insurance, advertising, accounting, legal, medical, and other services.

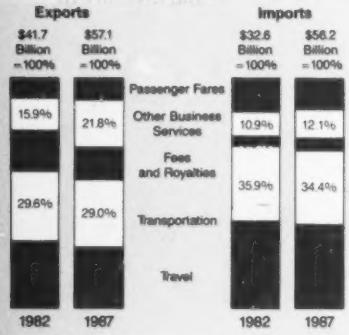
The OTA estimates that in 1984, for instance, exports of services—officially reported at $44 billion—may actually have been underreported by $25 to $47 billion. With service imports also underreported by an estimated $16 to $33 billion, the 1984 surplus on services would have come to about $14 billion versus an official report of $2.3 billion. While even the more realistic, much larger surplus calculated by the OTA pales when compared to 1984's $114 trade deficit, more accurate reporting of service transactions would put them in a better light with respect to the country's overall balance of payments.

Apart from purely statistical shortcomings, a major difficulty in getting a proper handle on the services trade is that their provision frequently is linked to that of goods and hence is not counted separately. As a Commerce Department analyst observes, "Services and goods are often inextricably bundled. The sale of a new computer by a U.S. company inevitably will involve design, consulting, installation, and software services, but the entire transaction will probably be recorded as merchandise trade rather than services trade." (He also remarked that interest and dividend payments—not included in this discussion—would be entirely recorded as investment income, even though a significant part of the payments might cover such supporting services as planning, bookkeeping and billing).

Chart 3

Composition of Business Services Trade

(In Percent)



Source: Department of Commerce.

Along the same lines, a study prepared for the National Planning Association notes: "Domestic firms producing raw materials, goods or services provide management, data processing, accounting and other services from the home office to their mines, plantations, factories and offices abroad and in a sense are competing with foreign suppliers. If these services were provided to unaffiliated enterprises, they would be counted as exports but . . . they may not appear as trade items in intracorporate accounting."

The close link between merchandise trade and related services sheds light on another aspect of why services exports are unlikely to take off in the years ahead. Sales by foreign affiliates of U.S. companies, particularly of large U.S. multinationals, generally exceed those companies' exports from the United States. Since many service functions have to be performed or delivered in conjunction with a specific product, sales of services by the foreign affiliates of U.S. companies are likewise many times larger than exports of such services from the United States (Chart 4). This, incidentally, lends further strength to the argument that on the basis of their *worldwide* sales U.S. companies do not appear to have lost ground in world markets.

Physical pressure in a market is even more necessary for professional services. As one respondent to a Conference Board survey comments: "Effective client relations are critical to the success of professional service firms in any market. They require physical proximity and intimate knowledge of the language, business practices, laws, and regulations of the country and a understanding of national aspirations."

Barriers to Services

Foreign barriers to the "newer" kinds of services provide another obstacle to their rapid expansion across national borders. Despite the increasing importance of services to the world economy—total world exports of services are estimated at $400 billion a year—these transactions are not yet covered by the rules of the of the General Agreement on Tariffs and Trade (GATT). After much lobbying by the United States and other countries with major service industries, the GATT decided to include the sector in its current ("Uruguay") round of negotiations, however.

Chart 4

Worldwide Sales of Business Services by U.S. Multinationals, 1984

* Nonbank majority-owned affiliates

Source: Department of Commerce

The negotiations on services trade will not take within the established GATT framework, but will be a separate exercise paralleling the negotiations on goods. The two parts will come together at the end of the negotiating round, currently expected at end-1990. One important reason for this special treatment is the strong opposition of some developing countries, especially Brazil and India. These countries argue that their fledgling service sectors would be at a disadvantage in the negotiating process, since the industrial countries might bar imports of their goods unless concessions on services were obtained.

National restrictions on foreign involvement in sensitive sectors, such as banking, insurance, communications and leasing, have always existed—but recently their importance has come to the fore as such activities gained prominence on the international scene. As the National Planning Association study notes, the United States certainly is not without regulations of its own, such as in banking, shipping, and the "Buy American" provisions of many states. But the extent to which in many foreign countries services are either government monopolies or government-controlled introduces an automatic bias against any outside competitor and "this unequal bargaining position is aggravated as the United States continues to deregulate its own service industries, to the advantage of foreign as well as domestic suppliers."

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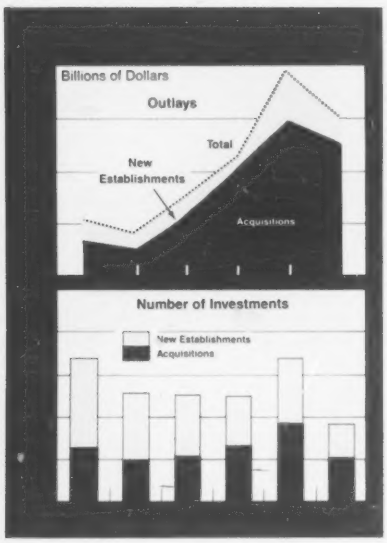
World Economic Monitor

Volume 3, Number 4 Fall 1988

FOREIGN DIRECT INVESTMENT IN THE UNITED STATES

Spending by foreigners to acquire or establish U.S. business enterprises fell noticeably last year, but remained substantially higher than at any time prior to 1986 (Chart 1). Last year's decline partly reflected changes in U.S. tax law under the 1986 Tax Reform Act that were less favorable to mergers and acquisitions and thus prompted a surge of foreign investments in the fourth quarter of the year. The *number* of new foreign investments has shrunk by about 50 percent since the early 1980s. This simply means that, just like in the domestic economy, individual deals have become very much larger.

Chart 1



Source: Department of Commerce

The biggest foreign acquisition in 1987 amounted to $7.6 billion. A $3.1-billion purchase took second place and the ten largest had a combined value of $22.9 billion. Only 60 percent of last year's transactions involved outlays of under $10 million, compared to over 80 percent in 1981 and 1982. Nevertheless, foreign acquisitions in 1987 continued to be dwarfed by mergers and acquisitions among U.S. firms, which were almost three times as large in value and ten times as many in number.

Several factors continued to render direct investment in the United States attractive to foreign firms:

*Last year's decline in the exchange value of the dollar not only lowered the cost of acquiring U.S. enterprises, but also induced foreign companies to shift more of their operations to the United States in order to maintain market shares.

*Corporate restructuring in the United States led many companies to shed units that were either unprofitable or unrelated to their major lines of business.

*Continued large trade surpluses in major foreign countries made funds available for investment abroad—and raised the spectre of increased protectionism in the United States.

*A number of large foreign multinationals were eager to expand and diversify beyond their own, much smaller home markets.

How Large A Presence?

In the heat of the debate over the "buying up" of the U.S. economy by foreign interests, it is often forgotten that foreign direct investment constitutes only a relatively small part of the continuing wave of incoming foreign capital. Thus, at the end of 1987, foreign direct investment accounted for only 21 percent of the nearly $1.3 trillion in privately owned foreign dollar assets. Correspondingly, last year only $10.5 billion was earned by foreigners from their direct investments in the United States, compared to $72.8 billion in earnings from financial assets.

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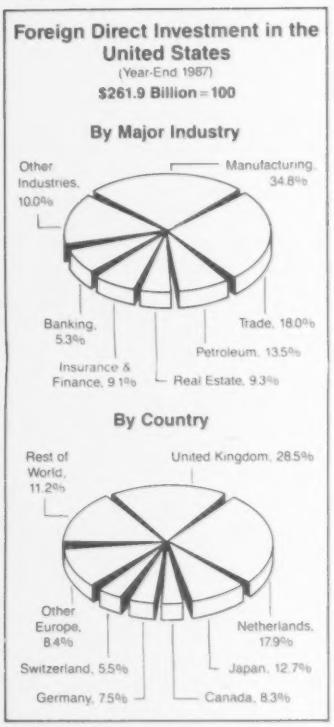
Chart 2



Source: Department of Commerce

Nevertheless, the question frequently is raised how prevalent the foreign presence in the United States has become. The most satisfactory measures available are 1) employment by foreign-owned U.S. affiliates relative to total employment, and 2) the share of foreign affiliates' assets and sales in major manufacturing sectors. (At the industry level, employment comparisons are not appropriate, since affiliate data by industry are gathered at the company level, while U.S. employment is classified by industry on an establishment basis).

In 1986 (latest year available), employment in foreign-owned affiliates accounted for 3.5 percent of total U.S. nonbank employment. For manufacturing alone—which accounted for over one third of foreign direct investment (Chart 2)—the affiliates' share of employment was 7.8 percent. These percentages look rather modest in light of the sharp rise in foreign direct investment in recent years. But they apply to a large base and there has been only limited investment by foreign interests in the service sector, which now accounts for about half of the U.S. economy. By individual state, there is only limited variation in the share of employment provided by foreign-owned firms (Table 1).

By assets and sales of major industry groupings, however, the foreign investment data are somewhat more revealing. They show, for instance, that direct investment is highly concentrated in certain industries, such as chemicals; stone, clay, and glass; and primary metals (Table 2). For manufacturing as a whole, the affiliates' share in total assets of all U.S. businesses was 12.1 percent in 1986—higher than their share of total U.S. employment (7.8 percent). This reflects the fact that foreign affiliates are most heavily represented in industries—such as chemicals and petroleum and coal products—that tend to be capital-intensive.

By a different measure, the U.S. affiliates of foreign companies also are fairly prominent on the U.S. economic scene—they are major exporters and importers. In 1986, affiliates provided 22.4 percent of total U.S. exports and took in 34.0 percent of all U.S. imports. The U.S. affiliates of Japanese parent companies, including the large trading houses, accounted for more U.S. trade than affiliates from any other country. In fact, the value of exports by U.S.-based Japanese-owned enterprises was equal to about 85 percent of total U.S. exports to Japan in 1986.

Foreign-owned affiliates in the United States have consistently shown a fairly large trade deficit and in 1986 contributed almost half of the overall U.S. deficit. This reflects the general trading pattern of foreign affiliates everywhere: They rely on their home countries, and particularly on their parent companies, for shipments of parts and components for further processing. By the same token, U.S. trade with the foreign affiliates of U.S. companies has consistently been in surplus. (What this implies for an accurate reading of the monthly trade figures is another story).

At best, any measure of the foreign presence in the U.S. economy is an approximation. For example, "foreign ownership" is defined as 10 percent or more of a firm's equity, but data on U.S. affiliate operations are not adjusted to reflect the various degrees of such ownership. Thus, in Delaware, "foreign" employers in 1986 provided work for as much as 11 percent of the state's labor force—simply because Delaware's single largest employer is 23 percent foreign-owned. Commerce Department estimates suggest that employment by foreign affiliates at industry level would be about 20 percent lower if it were adjusted for the actual percentage of foreign ownership.

Table 1
Share of Employment of Foreign-Owned Nonbank Affiliates, 1986
(By State)

State*	*Affiliate Employees* (thousands)	*Percent of State's Nonfarm Employment*
California	284.5	2.5
New York	284.5	3.5
Texas	211.3	3.2
New Jersey	161.7	4.6
Illinois	153.2	3.2
Pennsylvania	152.4	3.1
Ohio	127.1	2.8
North Carolina	119.2	4.3
Georgia	109.0	4.0
Florida	107.4	2.3

*Top ten states by number of foreign employment
Source: Department of Commerce

The U.S. Direct Investment Position

There has been much discussion lately of the United States as an international debtor—according to some versions, with a foreign debt larger than that of Brazil or Mexico. It would be more accurate to say that the U.S. international investment position has turned negative. Within this total picture, however, the U.S. position on direct investment has remained in the black (Chart 3) and may even be understated due to problems with the data.

For example, it is generally agreed that the book value of U.S. assets abroad, which is carried in the official statistics, is below actual market value. True, the book-value principle also applies to foreign direct investment in the United States, but in this case the degree of undervaluation is much smaller, simply because the investment is of much more recent origin. This undervaluation, plus other anomalies in the data, cast some doubt on the entire notion of the U.S. "debtor" position.

Foreign Direct Investment: Bane or Boon?

The rapid growth in the foreign presence in the United States in recent years is seen in many quarters as implying a loss of U.S. sovereignty and control over its own economy. Earlier this year, two prominent figures from the private sector voiced their concern over this "invasion." In January, Malcolm Forbes wrote in an editorial: "It's one thing for Japanese and Germans and others to buy U.S. Government bonds to finance our huge trade imbalances with them. But it's a whole and totally impermissible other thing for them to use their vast billions of dollars to buy great chunks of America's big businesses or take over the high-tech, medical or other strategic U.S. concerns." Forbes therefore proposed creation of a presidential commission to approve all foreign purchases of any significance, regardless of size.

Table 2
Foreign-Owned Affiliates' Shares in Assets and Sales of U.S. Manufacturing Industries, 1986

	Assets (%)	*Sales* (%)
Industries*		
Chemicals and allied products	32.5	29.5
Stone, clay, and glass products	22.8	20.2
Primary metal industries	20.5	19.0
Petroleum and coal products	14.9	13.7
Printing and publishing	11.8	8.0
Electric and electronic equip.	11.3	11.7
Food and related products	9.5	6.8
Paper and allied products	8.1	7.1
Fabricated metal products	7.6	6.3
Instruments and related products	6.4	5.7
All manufacturing	12.1	9.9

*Top ten industries by degree of foreign involvement
Source: Department of Commerce

Also, in January, in a speech to the Economic Club of Washington, Felix Rohatyn described himself as a recent convert to the idea of restricting foreign investment capital. He argued that recent stock market trends had created a dangerous vulnerability. Japan's Fuji Bank has a current market value, he noted, of $60 billion, or ten times that of Morgan Guaranty, while Toyota dwarfed Chrysler by $40 billion to $4 billion. Thus, he added, "it does not require a get leap of the imagination to see Japanese companies able to acquire controlling interests in major American companies at a relatively small cost to themselves...No major industrial power in the world, certainly not Japan, not even Great Britain, allows foreign control of major companies to be acquired without governmental approval." Rohatyn stressed that he was not proposing actual limits on foreign investment, but thought it logical to extend the review mechanism now in place for acquiring defense-related companies to "other sensitive areas."

These and related concerns found their way into a number of provisions in the trade bill debated by the U.S. Congress earlier this year. These provisions—which did not survive in the final version of the bill passed in July—would have reversed traditional U.S. policy by discriminating against foreign investors. Two particularly drastic provisions were included in the original House version of the bill:

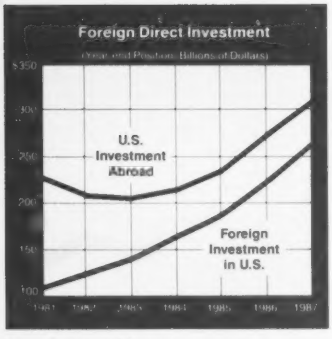
*A general registration requirement for foreign direct investors that would have forced them to disclose to the Department of Commerce financial and other corporate information not required of U.S. investors.

*General authority for the U.S. government to deny any investment or other transaction involving foreign firms thought to have adverse consequences for "national security and essential commerce."

Many observers, including public officials and major business executives, warned that any attacks on foreign direct investment in the United States would be tantamount to economic suicide. Former Federal Reserve Chairman Paul Volcker declared it not "in the best interests of he United States to discourage inflows of foreign capital," while the National Association of Manufacturers' President, Alexander Trowbridge, asked, "Why destroy our economy's greatest asset, a relatively free and open market?...We must look at these increasing inflows as part of a process of the competitive maturation of European- and Japanese-based international business enterprise." Similar feelings were expressed by senior executives of major U.S. corporations. They urged dropping the disclosure measure to avoid provoking retaliatory measures abroad.

One could add to these observations that changing the rules under which foreign direct investment enters the United States could easily discourage foreigners from holding any form of dollar assets, including U.S. Government securities—as well as drive up interest rates sharply. It is also possible to argue that for most of its history, the development of the U.S. economy was financed heavily by foreign investors, without giving them undue influence over the economy and U.S. economic policy.

Chart 3



Source: Department of Commerce

Certain protection procedures against foreign takeovers are already embodied in law and the Committee on Foreign Investment in the United States serves as a broader review mechanism. This group, made up of representatives of government agencies, was formed by executive order during the Ford Administration to ensure that OPEC funds (the so-called petrodollars) would not be used to buy up the U.S. oil industry. The committee can recommend against a foreign takeover or for altering the terms of a proposed takeover and actually has done do in a few cases. (Beyond these limited control mechanisms, one could conceive of a general overhaul of takeover legislation—but on a nondiscriminatory basis, applied to all investors, domestic as well as foreign).

Meanwhile, foreign direct investment will undoubtedly continue to come to these shores, even if at a somewhat slower pace than five to ten years ago. Given that the stock market valuation of all U.S. companies is on the order of $2 trillion ($2,216 billion at the end of 1987), it seems unlikely that direct investment will come to occupy an unduly large fraction of U.S. business as a whole. It is, nevertheless, quite possible that foreign investors will continue to concentrate in selected industries, thus stirring repercussions similar to those aroused by *le défi américain* of twenty years ago.

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The Conference Board

Economic and Business Environment Program

World Economic Monitor

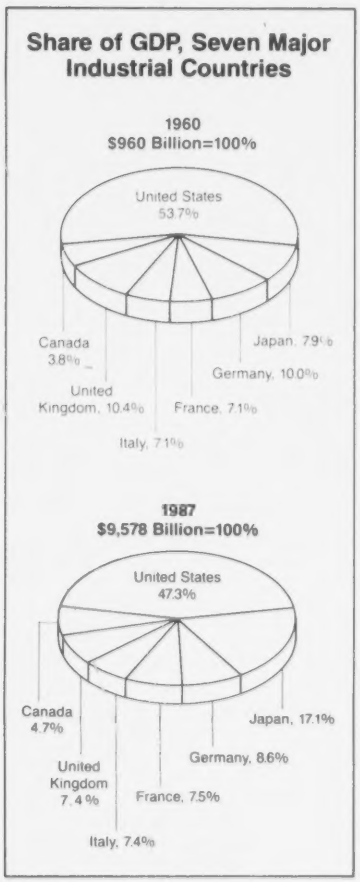
Volume 4, Number 1 Winter 1989

THE UNITED STATES IN THE WORLD ECONOMY

The internationalization of the American economy has outrun people's understanding of its implications. More than ever before, we cannot put our own house in order except by relating the American economy to the rest of the world.

William Diebold, Jr. in *Foreign Affairs,* Fall 1983.

Chart 1



Sources: Bureau of Labor Statistics; Brookings Institution; International Monetary Fund.

The economic relations of the United States with the rest of the world are vastly different today compared to 40 years ago, when this author began working in economic research. A seminal Commerce Department study of 1943, which was required reading in graduate school, viewed the international transactions of the United States basically in terms of "dollars made available to foreign countries. . .through purchases of goods, services, and investments abroad and the uses to which dollars are put by foreign countries in making similar purchases from the United States."

That fundamental equation still holds true, but the importance and weight of the participants, as well as the nature and volume of transactions in both directions, have changed considerably. As recently as 1960, official U.S. economic and military aid exceeded U.S. direct investment abroad, and until 1970 the United States enjoyed annual trade and current-account surpluses. By the late 1960s, however, import growth began to exceed export growth, and foreign direct investment in the United States started to rise more rapidly than U.S. direct investment abroad. By the late 1970s, the United States was attracting vast amounts of goods, services, and capital from abroad and was moving from a state of near self-sufficiency to one of international interdependence.

In the process, there have been major changes. Over the past 30 years:

- The share of the United States in the world economy has shrunk.
- The share of U.S. gross national product sold abroad has doubled, while the share of GNP spent on foreign goods and services has almost tripled.
- The dollar lost some of its preeminence, but remains the major international currency, for both official and private use.
- International capital flows have replaced trade in goods as the major type of international transaction.
- In this new environment, international economic policy cooperation is assuming an increasingly important role.

The U.S. and the World

The position of the United States in the world economy has shrunk over the last 20 to 30 years. The U.S. share of world gross domestic product fell from 27 percent in 1950 to 18 percent in the mid-1980s and its share of the output of the seven major industrial countries from 54 percent in 1960 to less than half in 1987 (Chart 1). This is generally ascribed to "catching up" by other major countries, especially Germany and Japan, and does not necessarily denote a worsening of long-term economic performance. The U.S. economy, Robert Lipsey and Irving Kravis note,

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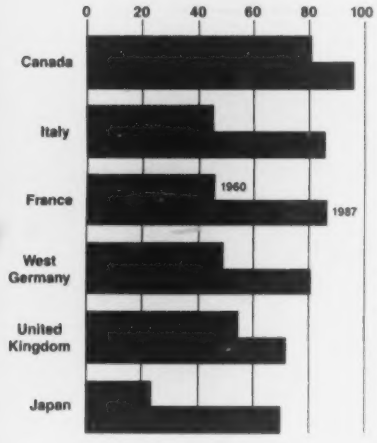
was "like a ship moving at its familiar moderate speed, while most of the other vessels that once lagged far behind, began to accelerate." What changed, in other words, was considerably more rapid economic growth in the rest of the world.

While the United States obviously loses some clout when other countries prosper, the well-being and living standards of its citizens are enhanced at the same time. A more interdependent world economy and economic growth abroad give the Untied States access to new and growing markets, allow it to benefit from other countries' technological innovations, and offer the U.S. consumer a greater variety of goods and services.

Chart 2

Relative Levels of GDP per Worker, Major Industrial Countries

(United States=100)



Sources: Bureau of Labor Statistics, Brookings Institution.

True, over the past 15 years U.S. productivity growth has slowed significantly and the real earnings of workers have stagnated. However, comparing the Untied States and other countries on that basis is a rather complex task. Judged solely by output per worker, the U.S. performance looks worst compared to other major industrial countries. The difference becomes more favorable, however, if productivity is measured by output per unit of labor input. By that measure, inexperienced workers represent less input than skilled ones. The difference is even less if one measures productivity by output per unit of labor and capital. The two oil shocks of the 1970s, for instance, affected the performance of the U.S. capital stock adversely, since it was older on average and hence less energy-efficient than that of most European countries and Japan.

By contrast, the difference in levels of output per worker, calculated on the basis of foreign currencies' actual purchasing power rather than market exchange rates, remains surprisingly large in America's favor. In 1987, for instance, the average French, German, and Japanese worker was still producing 14.7 percent, 18.9 percent, and 29.3 percent less than the average U.S. worker, according to this measure (Chart 2).

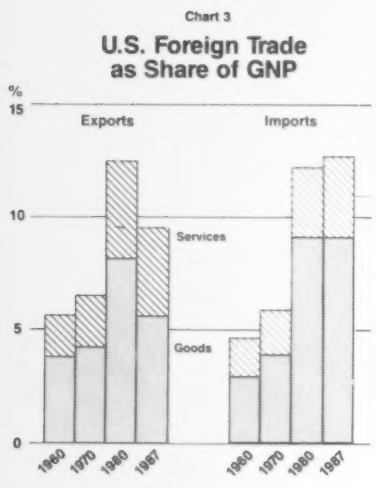
Comparisons based on actual purchasing power suggest therefore that U.S. living standards are still higher than those of other industrial countries. Such comparisons indicate that, while other countries may have done better than the U.S. in so-called tradable goods industries, they lag behind the U.S. in the distribution and service sectors. As Barry Bosworth and Robert Lawrenee of the Brookings Institution have observed, these countries' living standards would be considerably higher "if they could buy nontradable goods from the United States rather than at home. Because of the high cost of domestic nontradables, these nations...have much lower overall living standards than their efficiency in producing tradable goods would suggest."

The World and the U.S.

The increasing integration of the world economy has been reflected in more rapid growth of world trade than of world output since World War II. This phenomenon has been very pronounced in the case of the United States. Over the past 30 years, its growing involvement in the world economy has led to a doubling of the share of U.S.-produced goods and services going abroad and a near tripling of the share of U.S. gross national product being spent on goods and services purchased abroad (Chart 3).

Even at that rate, however, the United States remains one of the least "open" economies in the world, at least in terms of its merchandise trade. Other major industrial countries typically export between 20 and 30 percent of what they produce. Some smaller countries, such as Belgium and Ireland, export as much as half their GNP—for some, exports and imports combined equal or exceed GNP. As Governor Wallich of the Federal Reserve once remarked, with respect to its international transactions, the United States is like the ideal car—big on the inside, but small on the outside.

Chart 3



Source: Department of Commerce.

Increased involvement in the world economy has also incurred costs. With imports growing much more rapidly than exports and interest payments to foreigners now exceeding interest income on U.S. assets abroad, the U.S. external accounts have slid deeply into deficit. With foreign investments in the U.S. now exceeding U.S. investment abroad, the country has become, as the media like to put it, "an international debtor" (Chart 4).

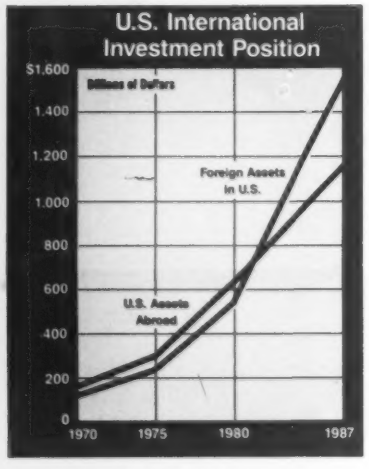
Theoretically, a current-account-deficit can always be financed. What matters is the mix of interest and exchange rates necessary to generate that financing. Because of the unique international role of the dollar, the United States has financing options not available to any other country—it pays for its external obligations in its own currency or what General de Gaulle once called an "exorbitant privilege." And while there is no specific point at which the deficit can no longer be financed, it is of course vulnerable to shifts in how foreign investors perceive trends in the U.S. inflation rate and in exchange rates.

Finally, there are those who view the external deficit of the U.S. as a sign of strength rather than of weakness. Thus, Milton Friedman wrote in *The Wall Street Journal* in December 1988, "The capital inflow that is the other side of the current-account deficit has enabled productive investment in the U.S. to be higher than the amount U.S. residents were willing to finance. It has thereby contributed to a higher national output and a more rapid rate of growth. That is precisely how the U.S. managed to grow so rapidly in the 19th century."

The Dollar's Changing Role

The shift in the international position of the United States has been closely associated with a corresponding change in the international role of the dollar. For a quarter century after the war, the stability of the U.S. currency was considered essential to world prosperity, and most countries regarded increases in their official dollar reserves as a sign of success in economic policy. In addition, the stability of the dollar in terms of gold was virtually unquestioned.

Chart 4



Source: Department of Commerce.

But when the perception of the United States as the center of the global economy began to fade, foreign countries began to reassess their attitudes toward the dollar. This reappraisal was stimulated, in part, by the U.S. authorities themselves: By the closing of the gold window in August 1971, the devaluations of the dollar late that year and in March 1973, and, perhaps more important, by the disinclination of successive Administrations to intervene to defend the value of the dollar in the exchange markets (or "benign neglect").

But the weakening of the role of the dollar can also be attributed to a growing disequilibrium between other countries' demand for the U.S. currency and the supply of that currency flowing into foreign markets. Especially in the 1970s, the total amount of dollars that foreigners desired, both to purchase goods and services from the United States and to add to official reserves, tended to fall well below U.S. financial outflows. The causes were numerous, including the inflationary financing of the Vietnam War. In a sense, this was ironic since the two world wars had helped to establish the dollar's preeminence and the international creditor position of the United States.

Yet even in the 1970s, reports of the dollar's imminent demise were exaggerated. They would be even more so now, when there is greater international economic cooperation. Although the dollar clearly has lost some of its lustre over the past thirty years, it has remained, virtually by default, the world's major currency. Its role as an international currency—both in the official and the private sphere—remains way out of proportion to the diminished role of the United States in the world economy. In 1987, the dollar still accounted for two-thirds of the world's official reserves (Table 1) and played an eminent role in international trade and investment (Table 2).

Surging Capital Flows

Table 1

Currency Composition of Official Foreign Exchange Reserves (In percent)

	1975	*1980*	*1987*
U.S. dollar	85.2%	68.6%	67.1%
Deutsche mark	6.6	14.9	14.7
Japanese yen	0.6	4.3	7.0
Pound sterling	4.1	2.9	2.6
Swiss franc	1.7	3.2	1.6
French franc)	1.7	1.2	
Netherlands guilder)	1.8	1.3	1.1
Unspecified currencies)		3.1	4.7
	100.0%	100.0%	100.0%

Source: International Monetary Fund.

The internationalization of the world economy has been accompanied—and at the same time hastened—by a sharp increase in the international mobility of financial capital. In contrast to the direct investment that characterized the period after World War II, these more recent capital flows generally do not involve direct control of business enterprises. The volume of such transactions has risen rapidly in recent years in relation to most other aggregates, such as output or trade. Between 1980 and 1986, for instance, world exports grew by 1 percent a year, while crossborder banking transactions grew by 15 percent annually.

Indeed, easily the biggest change in the world economy over the past 10 to 15 years is that flows of money have replaced trade in goods as the predominant type of international transaction—and hence as the prime force that drives exchange rates. Transfers of financial assets between countries now swamp the flow of revenues from trade in their effect on the demand for and supply of different currencies. Little is therefore to be gained by trying to divine the direction of the dollar from the monthly U.S. trade data as the media and the financial markets are wont to do!

A major implication of this phenomenon is the curtailment of the freedom a country's monetary authorities have to pursue their policies independently of developments and policies in other countries. In other words, without some sort of "coordination" of economic policies, exchange rates are likely to become still more volatile.

International Policy Cooperation

Table 2

The Dollar as an International Currency

Function	*Private Sector*	*Official Sector*
Unit of Account	Currency used in invoicing merchandise	Currency used in defining parities
Means of payment	Vehicle currency in foreign-exchange markets	Intervention currency in foreign-exchange markets
Store of Value	Currency in which deposits, loans, and bonds are dominated	Currency in which reserves are held

Source: Peter B. Kenen, *The Role of the Dollar as International Currency*, Group of Thirty, 1983.

A few years ago, Governor Wallich introduced a useful taxonomy of economic policy interaction among countries. To him, consultation/coordination/harmonization/cooperation were, in ascending order, "the terms by which nations recognize, sometimes reluctantly, that they are not alone in the world." Consultation includes not only the exchange of information, but also an explanation of current economic conditions and policies. Under cooperation, countries retain their national sovereignty, but allow the actions of other countries to influence their decisions. Harmonization is no more than a polite term, "indicating a somewhat greater reluctance to limit one's freedom of action." Ascending, finally, to coordination means relinquishing some or all decision-making powers to other countries or to international institutions. This, inevitably, involves some loss of national sovereignty.

Wallich concluded that growing world interdependence was not yet matched "by growing ability or willingness to cooperate in dealing with the results of interdependence." Probably, at the moment the best we can hope for is continued close and fruitful cooperation, such as is found in the G-5 deliberations, the annual economic summits, and the various other fora that deal with international economic and monetary affairs. In that respect, Governor Robert Heller of the Federal Reserve remarked last December, countries behave "like families that cooperate in certain neighborhood projects, such as snow removal, agreeing not to use noisy lawnmowers on Sundays, or keeping an eye on each other's houses to prevent burglaries."

Yet, even that process is still in its initial stages and, apart from occasional concerted intervention in the foreign exchange markets, little in the way of formally coordinated economic policy has emerged. Probably not enough is known about how the world economy hangs together to ensure that macroeconomic policy coordination would improve the outcome.

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World Economic Monitor

Volume 4, Number 2 Spring 1989

THE CHANGING PATTERN OF WORLD TRADE

If we look at forecasts of the most dynamic world markets by the year 2000, we find medicine, health, leisure, information technology and optoelectronics singled out.

Corning Glass Works, *Annual Report*, 1988

Over the past few years, vigorous business activity in the major industrial and a number of developing countries has been accompanied by a surge in world trade. Both the dollar value and the volume of world exports reached record levels in 1987 and 1988. Additional, if somewhat more modest, gains are projected for this year.

At the same time, this upsurge contributed to—and perhaps even consolidated—major changes in world trading patterns under way for the past 10 to 15 years. Products traded reflect a general shift away from basic goods, such as iron, steel, and paper, to high-tech items, such as electronics and telecommunications equipment. And a number of Asian countries, especially the so-called newly industrializing countries (NICs), are now in the top ranks of world exporters.

These changes are likely to continue and even to intensify between now and the year 2000. They will coincide with further globalization of production and assembly facilities and significant shifts in population patterns—and hence in markets—between the industrial and the developing countries.

Total Trade Surges

Six consecutive years of growth have brought the volume of world trade to a record level, of close to one-third above the recession level of 1982. In 1987, the *value* of world merchandise exports rose by 18 percent, to a record $2.3 trillion, and by another estimated 12 percent, to $2.6 trillion last year (Chart 1). Or, in real terms, the *volume* of world trade expanded by 5 percent in 1987 and by another 7-8 percent in 1988. For 1989, the International Monetary Fund projects further growth of 5-6 percent.

As has been true after earlier business downturns, merchandise trade has recovered much more rapidly than world output. In each of the past three years, for instance, the growth in trade volume has considerably exceeded the more or less stable rate of 3.0-3.5 percent annual growth in world production (Chart 2). However, within this pattern there were important differences among major product groups:

- In 1987, manufactures resumed their traditional role as the most dynamic category of merchandise trade, after trailing minerals and fuels in 1986 (Chart 3).
- In volume terms, agricultural trade had its best year since 1981, increasing almost in line with the expansion of total trade.
- In contrast, trade in mining products—60 percent of which consists of fuels—grew by only 1 percent in 1987, after having been the fastest growing category in 1986.

External Imbalances Narrow

In 1988, the United States contributed approximately one-third of the year's growth in world trade, with a rise in export volume of over 25 percent or almost twice that

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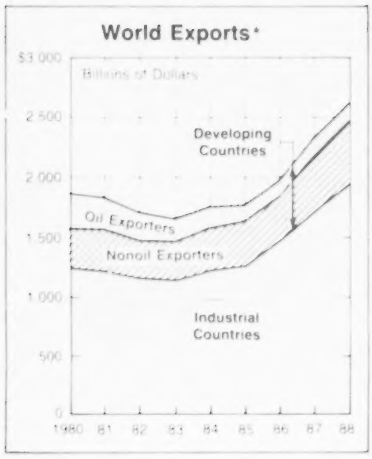
of 1987. The IMF estimates that by 1989 U.S. exporters are likely to regain most of the loss in market shares attributable to the appreciation of the dollar in the early 1980s.

Chart 1



*Excluding centrally planned economies
Source: International Monetary Fund

On the import side, growth last year was especially buoyant in Japan, with an estimated rise of 15 percent in volume terms, compared with 9 percent in 1987. Germany's import volume likewise is estimated to have grown by more than 6 percent in 1988.

Table 1
Current-Account Balances
(as percent of GNP)

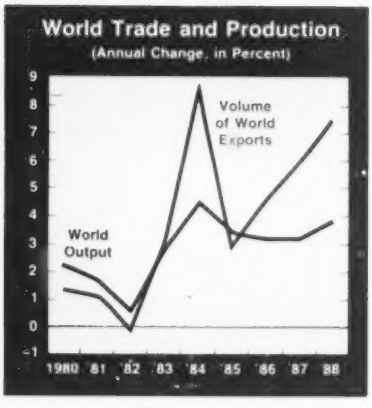
	1980	1986	1987	1988	1989 (est.)
U.S.	0.1	-3.3	-3.4	-2.6	-2.5
Japan	1.0	4.3	3.7	2.8	2.7
Germany	1.7	4.4	4.0	4.1	4.3
Four Asian NICs*	6.8	10.8	11.2	8-10	5.5-7.5

*Hong Kong, Korea, Singapore, and Taiwan
Sources: International Monetary Fund; Commission of the European Communities.

These shifts in export and import patterns are leading to a significant narrowing of trade imbalances, in volume terms. Progress is less evident when balances are expressed in dollar terms, because of fluctuations in exchange rates. Relative to gross national product, however, the imbalances in the current account of the United States and of Japan are projected to narrow by 1 percentage point between 1987 and 1989. The combined current-account surplus of the four Asian NICs is likewise projected to decline (Table 1).

The current surplus of Germany, on the other hand, is forecast to rise slightly relative to GNP. This reflects a number of factors, including brisk worldwide demand for the types of capital goods in which Germany specializes and weaker domestic demand growth vis-a-vis the country's trading partners.

Chart 2



Source: International Monetary Fund

Table 2
Top 15 Products in World Trade
(by value)

	Share in total trade 1986	Rank 1986	Rank 1983	Rank 1973
Passenger cars	5.3%	1	2	4
Crude petroleum	5.2	2	1	1
Office machines and data-processing equipment	3.3	3	6	20
Textile yarn and fabrics	3.1	4	4	3
Clothing	3.1	5	5	9
Iron and steel	3.0	6	3	2
Petroleum products	3.0	7	13	7
Motor vehicle parts and accessories	2.6	8	7	8
Plastic articles and materials	2.5	9	8	15
Wood products and paper	2.2	10	10	6
Organic chemicals	2.1	11	18	18
Fruits and vegetables	1.7	12	14	11
Telecommunications equipment and parts	1.5	13	17	17
Natural and manufactured gas	1.5	14	9	47
Transistors and valves	1.4	15	19	48

Source: GATT

Shifts in Major Product Groups

The commodity pattern of world trade has been changing markedly in the 1980s, even more so if compared to the early 1970s. A strong expansion in trade for a great variety of manufactured goods contrasts with stagnation or decline in trade in primary commodities and iron and steel (Table 2). Particularly strong trade showings were made by office machinery/data processing equipment (up by an average of 15 percent a year in the 1980s) and telecommunications equipment (10.5 percent). In fact, the first ten items in Table 2 accounted for one-third of world trade in 1986.

Shifts among Major Trading Countries

Highly aggregated data tend to conceal often large differences in the trade performance of individual countries. Thus, increases in 1987 export volume ranged between 20 and 32 percent for several Asian countries. Expanding export volumes also were registered by some of the major debtor countries, as well as by some industrial countries, including the United States (Table 3). By contrast, other debtor countries, as well as OPEC as a group, recorded substantial declines in their exports.

Table 3
Top 15 Gainers in 1987 Exports
(by volume)

Hong Kong	32.5%	Singapore	19.0%	Norway	13.5%
Colombia	26.5	Thailand	17.5	Portugal	11.0
Korea	24.0	Brazil	15.0	Mexico	11.0
Turkey	22.5	U.S.	15.0	Malaysia	8.5
Ireland	19.0	Taiwan	14.5	Spain	7.5

Source: GATT

As mentioned, manufactured goods proved to be the most dynamic sector in world trade in 1987—and much of that reflected the continuing inroads made by the Asian NICs into the manufactures trade of the industrial countries (Table 4).

Trade and the World Economy

The developments in world trade in recent years are generally encouraging. In both 1987 and 1988, the expansion of trade has been well above the average for the 1980s. However, this positive trend must be tempered by the persistence of third-world debt and the continuing large imbalances among the three leading trading nations. World economic activity—and hence world trade—will also continue to be affected by patterns of inflation and unemployment and, perhaps equally important, by individual countries' policy responses to those developments.

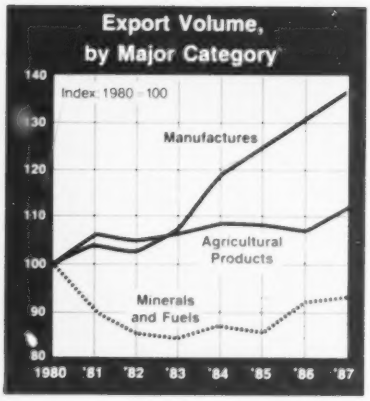
But there are also two longer term trends that will have an impact on how world trade develops and what patterns it will exhibit. The first is population. The latest UN projections indicate that the industrial countries are entering an era in which they can less and less afford the lower economic growth that results from delayed or bungled structural adjustments. The industrial countries will account for only 50 out of each 1,000 new people added to world population during 1990-2010. Thus, unless immigration policies are eased considerably, the industrial countries as a group are facing close to zero population growth, a gradually aging population, and a steady rise in the ratio of retired people to active workers. As a result, for many goods and services the greatest potential for market growth will have to lie in the developing countries.

The other trend concerns the impact of rapid technological progress. New and evolving technologies—including biotechnology, laser technology, optical fibers, and energy and space technology—are promoting product innovation and differentiation. They thereby broaden the scope of greater specialization and product diversification in international trade. These new opportunities are enhanced further by major advances in transportation which tend to reduce the cost of moving

goods internationally. At the same time, advances in telecommunications are stimulating the growth of trade in services and of global financial markets.

At the level of the individual company, all these changes have worked to internationalize production and distribution—to create the global factory—and have resulted in the growth of many small- and medium-sized firms whose economic health now depends on the availability of worldwide markets. This factor explains, in part, why trade has tended to increase more rapidly than world output.

Chart 3



Source: GATT

Table 4
World's 15 Leading Exporters of Manufactures
(share in value of world manufactures trade)

	1987	1980	1973
West Germany	15.2	14.8	17.0
Japan	13.0	11.2	10.0
U.S.	10.5	13.0	13.0
France	6.4	7.4	7.3
Italy	6.0	5.9	5.3
U.K.	5.7	7.5	7.0
Belgium-Luxembourg	3.6	4.1	4.9
Canada	3.3	2.8	3.5
Netherlands	3.3	3.4	3.9
Taiwan	2.8	1.6	1.1
Hong Kong	2.6	1.6	1.3
Korea	2.6	1.4	0.8
Switzerland	2.5	2.4	2.4
Sweden	2.2	2.2	2.6
USSR	1.8	1.8	2.2

Source: GATT

As the GATT reports in its 1987-88 review of world trade, the globalization of production and markets tends to increase the cost of non-tariff barriers to trade, even if the level of these barriers remains unchanged. As foreign goods become available in greater quantity and at lower cost, quantitative restrictions and other non-tariff measures limit consumer access to these opportunities. Such measures not only raise the prices of foreign goods (as was shown by the higher cost of Japanese car imports under the U.S. voluntary restraint agreement), but also ensure that price differentials continue to rise as foreign products become cheaper. As the GATT notes, "the resulting loss of economic efficiency is particularly damaging at a time when the challenges posed by worldwide population trends make higher rates of economic growth...more important than ever."

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THE DOLLAR AND U.S. TRADE

Only one thing is more impressive than the dollar's current strength: the ingenuity of economists in explaining its every move, always after the event, of course.

The Economist, May 20, 1989

The U.S. trade account's relatively good showing in March and April—with deficits of $9.5 billion and $8.3 billion, respectively—leads many observers to claim that the trade deficit's downward adjustment is continuing. Moreover, March's sharp 18 percent rise in merchandise exports (5.8 percent, seasonally adjusted) is cited as evidence that the U.S. economy is shifting its focus to external demand, just when domestic demand may be slowing.

Despite these promising signs, however, the bottom line is that little or no further improvement in the trade deficit will be seen this year, largely due to continuing substantial deficits in several key categories and the recent strength of the dollar.

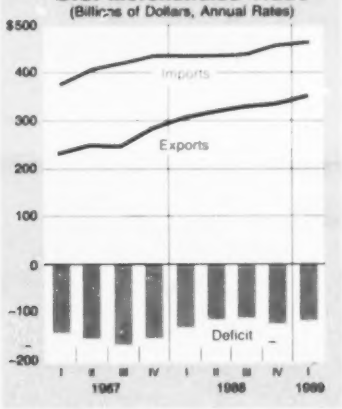
Trade Improvement Deceptive

Conclusions derived from monthly trade data have always rested on somewhat shaky ground. First, while the recent data look good, the first-quarter performance merely returns the trade deficit to levels reached in the second and third quarters of 1988 (Chart 1). Second, and perhaps more important, U.S. trade flows by sector show virtually no improvement in three key categories—automotive, consumer goods, and industrial supplies (including petroleum and petroleum products).

Chart 1

U.S. Merchandise Trade

(Billions of Dollars, Annual Rates)



Source: Department of Commerce

In the first four months of 1989, these three categories produced a deficit almost two-thirds larger than the overall trade deficit (Table 1). This contrasts unfavorably with the first four months of 1988, when the combined deficit of the same three categories was only one-third larger than the total deficit. In other words, when comparing these two periods, the bulk of the reduction in the trade deficit reflects improved trade in agricultural products and in the "other goods" category, which includes military equipment, low-valued shipments, and undocumented exports to Canada. The latter two figure among the top ten U.S. exports (Table 2).

Table 1

U.S. Trade Balance by Major Sectors ($ billion)

	Jan.-Apr. 1988	*Jan.-Apr. 1989*
Consumer goods	-22.0	-19.9
Automobiles	-18.9	-19.6
Industrial supplies	-10.5	-12.8
Other goods*	8.4	13.1
Capital goods	3.3	3.4
Food, feed, and beverages	1.6	4.0
Total	-38.1	-31.8

* Includes military equipment, shipments valued at $10,000 or under, undocumented exports to Canada, and U.S. goods returned.

Source: Department of Commerce

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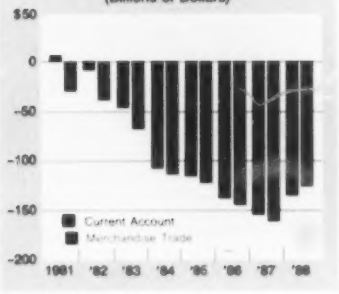
Table 2
Top Ten U.S. Exports and Imports, 1988

Exports	*Value ($ billion)*	*Imports*	*Value ($ billion)*
Aircraft	20.3	Motor vehicles	47.5
Vehicle and tractor parts	13.2	Crude petroleum	25.8
Office machine parts	12.6	Motor vehicle parts	14.7
ADP machines and equipment	11.6	Petroleum products	12.0
Shipments valued at $10,000 or under*	10.4	Office machine parts	11.5
Electronic components	10.4	Electronic components	11.5
Motor vehicles	9.1	Telecommunications equipment	9.7
Undocumented exports to Canada	8.3	Special transactions +	8.4
Organic chemicals	7.8	ADP machinery	8.3
Measuring and checking instruments	7.4	Footwear	8.0

* Over half of which to Canada
+ Mainly U.S. goods returned or reimported
Source: Department of Commerce

Chart 2
U.S. Balance of Payments
(Billions of Dollars)



Source: Department of Commerce

Even if the first four months' pace held for the remainder of the year, the deficit would only decline to around $110 billion from $120 billion last year. But even such modest improvement is unlikely to be achieved: Oil imports are set to rise over 1988 so that, even with prices unchanged, the oil import bill will increase. But even more important is the dollar's strength since early this year, which could result in a replay of the first half of the 1980s, leading to higher monthly deficits.

A stronger dollar would also perpetuate the decline in the value of U.S. corporations' repatriated earnings, thus worsening the already weak position of the services account. Although largely unnoticed, last year, for the first time, the deterioration in services resulted in an overall balance-of-payments deficit in excess of the deficit on merchandise trade (Chart 2). As recently as 1987, receipts of income on U.S. foreign assets (both direct and portfolio investment) had comfortably exceeded payments on foreign-owned dollar assets by over $20 billion. In 1988, that margin shrank to $2.2 billion, and in two of four quarters was actually negative. Preliminary data for the first three months of 1989 show payments to foreigners exceeding receipts by $3.5 billion. Even if the U.S. payments deficit remains at its current level, payments to foreigners on their dollar investments will continue to rise and thus offset whatever gains the trade account may register.

Sharing the Adjustment Burden?

While the three largest external imbalances—of the United States, Germany, and Japan—appear to be stabilizing or even declining slightly relative to GNP, in nominal terms these imbalances are projected to widen in 1989-90. Moreover, recent research by William Cline of the Institute for International Economics indicates that a reduction in the U.S. current account deficit may have unfavorable implications for its major trading partners. Cline finds that the cost of reducing the U.S. external deficit could easily be bigger external imbalances elsewhere. His model suggests that even if the dollar were to depreciate by another 10 percent against most currencies, countries that already have trade deficits would bear a disproportionately large share of adjustment, while the surpluses of Germany and Japan would remain virtually unchanged.

The reason is that both Germany and Japan have sizable trade surpluses with industrial countries apart from the United States. Since global payments and imbalances are recorded in dollars, a depreciating dollar will automatically boost the dollar price of German and Japanese exports and hence raise the value of their trade surpluses with those other countries. For deficit countries, such as France

and Italy, on the other hand, declining surpluses with the United States might be offset (or even more than offset) by bigger deficits with Germany and Japan.

Explaining the Dollar

Puzzlement surrounded the strength of the dollar earlier this year. At first, political uncertainty in both Germany and Japan were seen as contributing heavily to the dollar's rise. But this factor was quickly eliminated. Japan's new prime minister is untainted by the Recruit scandal. In West Germany, the popularity of the ruling conservative coalition received a boost from a cabinet shuffle, the abolition of the withholding tax on interest payments, and the Chancellor's strong stance in favor of negotiations on short-range nuclear weapons. While the events in China undoubtedly provided some "safe haven" support for the dollar in June, especially against the yen, this issue is receding as a market factor and will continue to abate unless the situation flares up again.

Once these considerations are discounted, there remains the argument that there now is a somewhat higher basic transactions demand for the dollar. But this explanation does not seem to square with the facts. Using the demand for international bank credit as a proxy for the worldwide demand for dollars, Deutsche Bank Capital Corporation notes that the share of international bank claims denominated in dollars fell from 76 percent at the end of 1983 to 58 percent at the end of 1988. Over the same period, the share of the yen rose from over 3 to almost 11 percent and that of the D-mark from 6.5 to 10 percent. (Even though half of these changes reflected exchange rate movements, the other half clearly was the result of increased volume.)

There is little validity to the further argument that foreign investors are currently "underinvested" in dollar assets and that the recent demand for dollars therefore represents an effort to "catch up." As counterpart to the deterioration in the net international investment position of the United States, foreign investors since 1982 have accumulated, on balance, nearly $700 billion of dollar assets, both direct and portfolio, giving them control, both directly and indirectly, of well over 10 percent of the U.S. capital stock and some 13 percent of the outstanding public debt.

An alternative explanation lies in the continued interplay or feedback between the U.S. balance of payments deficit and the inflow of foreign capital. Technically speaking, there is no apparent reason why the United States (or any other country) cannot run a current-account deficit indefinitely. Foreigners will not "run out of funds": The world economy is growing and, consequently, the resources available for lending are increasing continuously.

In fact, as Paul Krugman of MIT pointed out recently, the real world decisions that determine the current account do not change quickly. "For the most part," he notes, "the decisions that will determine the U.S. current account over the next two years have already been made." Even if the financial markets should become less bullish about the United States, they cannot do much to reduce the external deficit and hence the rate of capital inflow. Conversely, even if the United States becomes more attractive as a site for investment, capital inflows probably would not accelerate by much. If one subscribes to the notion that cause and effect run the other way, then continued strong demand for dollars and dollar assets would ensure continuation and even deterioration of the external deficit.

A Difficult Adjustment

The magnitude of the adjustment in the U.S. external accounts ultimately depends on two factors that, on the basis of recent experience, do not appear too promising—the responsiveness of the trade balance to changes in the dollar and the strength of economic growth abroad. Whether and by how much trade reacts to changes in the dollar depends on how the demand for U.S. goods responds to changes in their price relative to those of competing foreign goods, and also on whether and to what extent changes in import prices are actually transmitted (or

"passed through") by the foreign supplier. The weaker these responses are, the greater the decline in the dollar needed to achieve a given improvement.

Chart 3
U.S. Export and Import Prices

Sources: Bureau of Labor Statistics, Morgan Guaranty

Over the past few years, the responsiveness of U.S. exports and imports to changes in the dollar and in relative prices appears to have been significantly smaller than in earlier periods. This lower overall response may indicate that the U.S. consumer has become somewhat inured to the price changes of foreign-made goods. It certainly means that foreign producers have refused to fully "pass through" the effects of a weaker dollar to the prices charged to U.S. buyers (Chart 3). Thus, the Bureau of Labor Statistics estimates that between March 1985 and December 1986 foreign manufacturers of machinery and transport equipment—which is heavily influenced by exchange-rate fluctuations—passed through only 48 percent of price increases related to the decline of the dollar. In the most recent period—1986 to 1988—only 62 percent of such increases were passed through.

The strength of real growth in the U.S.'s major trading partners also has connotations for the U.S. trade balance. Reducing that imbalance requires some combination of slower domestic growth in the U.S. and dollar depreciation, both of which will have to be more pronounced the slower real growth abroad. Without adequate and sustained growth abroad, so the reasoning goes, it may well be impossible to achieve substantial further improvement in the U.S. trade deficit over the next few years. One obvious obstacle is that over one-third of the U.S.'s total trade in both directions is with but two countries, Canada and Japan (Table 3).

Table 3
Top Ten U.S. Markets and Suppliers, 1988

Market	*Percent of exports*	*Supplier*	*Percent of imports*
Canada	22.0	Japan	20.3
Japan	11.7	Canada	18.5
Mexico	6.4	Germany	6.0
United Kingdom	5.7	Taiwan	5.6
Germany	4.4	Mexico	5.2
Taiwan	3.8	Korea	4.6
Korea	3.5	United Kingdom	4.1
Netherlands	3.1	France	2.8
France	3.1	Italy	2.6
Belgium	2.3	Hong Kong	2.3
	66.0		72.0

Source: Department of Commerce

In the case of Canada, as much as one-third of trade is between U.S. companies and their Canadian affiliates, so that faster Canadian growth relative to the United States may not be very meaningful. In the case of Japan, sturdier domestic growth may very well translate into increased purchases of U.S. goods made in Japan, rather than into significantly higher U.S. exports, given Japan's still formidable structural and administrative barriers to such exports. As has been remarked repeatedly, even if all the barriers to trade were swept away, the U.S. would still record a bilateral trade deficit (albeit a somewhat smaller one) with Japan, just as it has since 1965.

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